PREQIN SPECIAL REPORT: THE FUTURE OF ALTERNATIVES 2025

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preqin

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Data Pack

The data behind all of the charts featured in this report is available to download for free. Ready-made charts are also included that can be used for presentations, marketing materials, and company reports.

Download the Data Pack

Contents

Future of Alternatives 2025 was a digital initiative that launched on 4 November 2020 and ran throughout the month. This report is a summary of the digital series, which can be viewed at www.preqin.com/future.

CEO's Foreword

What does the future hold for the alternative assets industry? As we approach the end of a year that can justifiably be called 'unprecedented,' it's a trillion-dollar question.

Preqin's position as 'The Home of Alternatives' gives us a unique, data-driven perspective on these dynamic asset classes. We have taken an in-depth look at how megatrends affecting all businesses will impact alternatives over the next five years, and published our predictions for asset classes, investors, and regions throughout November 2020.

The headline is that we believe assets under management (AUM) in alternatives will continue to grow, rising at a CAGR of 9.8% for the next five years to hit $17.16tn in 2025. The twin forces of persistently low interest rates and strong returns across asset classes, each with differing risk/return profiles, will push and pull capital to alternatives.

Preqin's Data Science and Research Insights teams designed an AUM forecast model that utilizes a range of sub-models to achieve its outputs, with the impact of the COVID-19 pandemic reflected in the data. The dataset includes historical AUM across asset classes and geographies, as well as fundraising and deals, overlaid with historical time series for a range of macroeconomic data, such as GDP, inflation, and central bank policy rates.

Our forecast is supported by the findings of our *Future of Alternatives 2025 Investor and Fund Manager Surveys*. More than 100 investors and 100 fund managers responded to a detailed questionnaire conducted over August and September 2020. Their expectations and intentions clearly support our forecast of strong growth in AUM over the next five years.

Mark O'Hare
CEO

Preqin
www.preqin.com

Future of Alternatives 2025 represents a huge collaborative effort from Preqin teams around the world. We would like to extend special thanks to our network of industry contacts who helped shape our thinking, and to our partners in this study, Adamantem Capital, AIMA, Axiom Asia Private Capital, CAIA Association, Citco Fund Services, Gulf Capital, and Prospect Avenue Capital.

Preqin has shared its journey with many investors and fund managers. We look forward to walking alongside you into an exciting future.

Executive Summary

Alternatives AUM will increase at a CAGR of 9.8% to hit $17.14tn in 2025

Persistently low interest rates will attract investors drawn to the promise of outperformance, diversification, and lower correlation with public markets. Our forecast is supported by our *Future of Alternatives 2025* survey, in which 81% of investors said they expect to increase allocations to alternatives.

We expect **private equity's** share of alternatives AUM to rise from 41% to around 53%, as the segment delivers a CAGR of 15.6%. While all regions will see growth, Asia will be a huge driver.

Private debt is expected to be one of the fastest-growing asset classes, with AUM increasing at a CAGR of 11.4% over the next five years. In a low interest rate environment, high single-digit returns will be attractive.

We expect **hedge funds** to remain the second-largest alternative asset class with AUM of $4.23tn in 2025, but our forecasted CAGR of 3.6% is one of the lowest. That growth will be performance driven, offsetting outflows from investors opting for liquid alternatives.

We see **private real estate** AUM growing at a CAGR of 3.4% from 2020 through 2025, a much lower rate than the 8.9% achieved in the preceding 10 years, with a significant evolution of property types and products, such as vehicles offering bond-like returns.

Infrastructure spending is set for a huge increase, with attention focused on Sustainable Development Goals. We expect a CAGR of 4.5% for **private infrastructure** AUM over the next five years, though low public sector borrowing costs mean private investors will have to work hard to carve out a niche for themselves.

Energy will continue to dominate **unlisted natural resources** with the updated Paris Agreement targets driving unprecedented investments in energy efficiency, renewable energy, and low-carbon technologies. We expect AUM to increase to $271bn by 2025.

Investors: Pushed and Pulled to Alternatives

Historic outperformance from alternatives and expectations of lower returns from other assets, especially fixed income, are the seemingly unstoppable forces driving capital to alternative assets. Ever more sophisticated investors will demand closer relationships with fund managers; product innovation; and improvements in reporting, transparency, and ESG standards.

Despite changes to US 401(k) regulations opening a $6.5tn market to private equity, only a third (35%) of surveyed managers expect to source a greater proportion of capital from **retail investors**. In absolute terms, retail's capital contribution will be small, but the increased scrutiny that will come with it will reverberate through the market.

All Around the World

North America, the world's largest alternatives market, is reaching maturity with many investors near allocation ceilings. We expect growth in North America to be modest, but AUM will still rise, hitting $8.6tn in 2025.

Pensions have been a key issue in the unrest in many countries in **Latin America**. Facing serious underfunding issues, pensions are increasing allocations to international alternatives funds.

Asia-Pacific will be fertile ground over the next five years for alternatives investors as the region's economies transition toward domestic demand and companies look to service the ever-expanding middle classes. We expect alternatives AUM in the region to grow at a world-beating 25.2% CAGR through to 2025.

We see continued growth in alternatives in **Europe** over the next five years, with AUM forecasted to rise from $2.21tn in 2019 to $2.83tn in 2025. The region's challenges, from its aging populations and infrastructure to inefficient companies, will also be the source of its opportunities.

The position of the **Middle East** in the alternatives universe is changing, as regional institutions – veteran investors in international funds – turn their focus closer to home. Private capital funds are positioning themselves to help the region's conglomerates compete on the global stage.

Africa's private capital markets are in their infancy, but investors are more positive on the region's prospects, with a quarter in our survey expecting Africa to provide the best investment opportunities in 2025. The long-delayed AfCFTA agreement will encourage interregional trade.

Megatrends Will Reshape Alternatives

Regulation and investor demands have made **ESG** mainstream. Europe leads, with 63% of invested alternative assets managed under sustainable principles. With an increasing proportion of investors viewing ESG as a future value driver, the challenge will be integrating it into the investment process.

An increasing body of research is showing the benefit of **diversity** in investment teams. Investors and fund managers recognize this, but only a minority plan to adopt formal policies.

Hedge funds have been data analysis pioneers and a growing proportion of private capital managers are developing or buying access to **big data** tools. A desire to report better information faster and reduce costs will drive adoption of more analytical tools at the fund manager level.

For alternatives managers and investors, embracing **digital transformation** is not optional. We expect the advantages of technology to go far beyond traditional cost-saving automation and paper-process digitalization for fund operations or compliance to holistically address the entire alternative investment value chain.

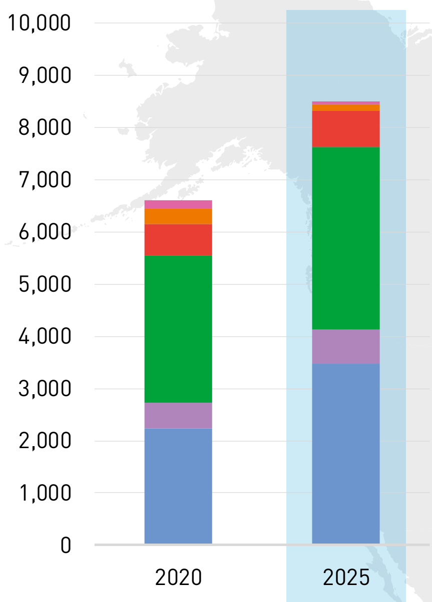
A balance of **public and private market** allocations brings significant diversification benefits. While illiquid assets command a return premium, experience in past times of market stress, notably around the Global Financial Crisis (GFC), was that being locked into investments proved beneficial to investors from a return perspective, even if it did exacerbate liquidity issues across the broader portfolio. We believe there is considerable scope for further growth in private market allocations before a natural ceiling is reached.

Many within the alternatives industry passionately believe in the superiority of the ownership model from a performance, governance, and incentivization perspective. Few outside it do – **regulation** tops the list of concerns for fund managers. Greater transparency would enhance the industry's **reputation** and ensure regulation is appropriate.

COVID-19 will have a lasting legacy for relationships between entrepreneurs, fund managers, and investors, and for the companies and sectors in which they invest. The alternatives landscape will look different **after the pandemic**.

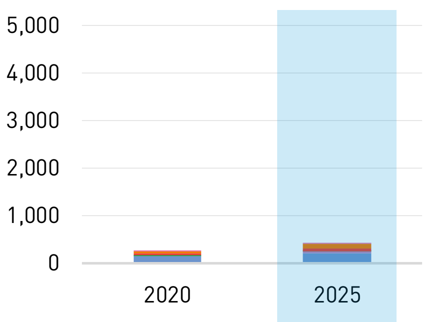
Asset Class AUM Growth by Region

North America-Based Assets under Management ($bn)



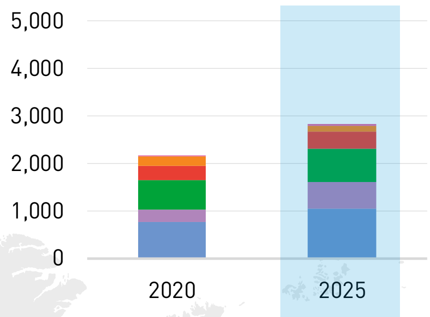
	2020	2025	CAGR
Private Equity	2,229	3,473	9.3%
Private Debt	506	654	5.3%
Hedge Funds	2,806	3,494	4.5%
Real Estate	607	698	2.8%
Infrastructure	286	131	-14.4%
Natural Resources	173	50	-2.4%

Rest of World-Based Assets under Management ($bn)



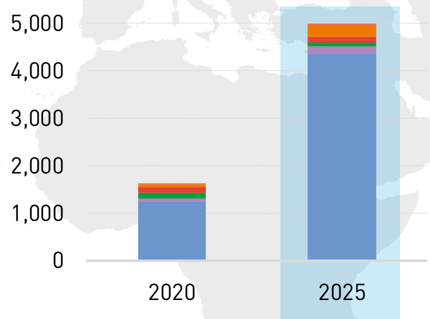
	2020	2025	CAGR
Private Equity	132	202	8.9%
Private Debt	10	34	26.8%
Hedge Funds	26	11	-15.1%
Real Estate	38	47	4.2%
Infrastructure	34	112	27.2%
Natural Resources	13	22	10.3%

Europe-Based Assets under Management ($bn)



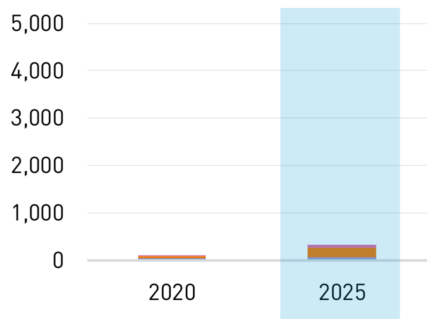
	2020	2025	CAGR
Private Equity	759	1,038	6.5%
Private Debt	259	576	17.3%
Hedge Funds	630	694	1.9%
Real Estate	290	367	4.8%
Infrastructure	218	106	-13.5%
Natural Resources	11	45	32.4%

Asia-Pacific-Based Assets under Management ($bn)



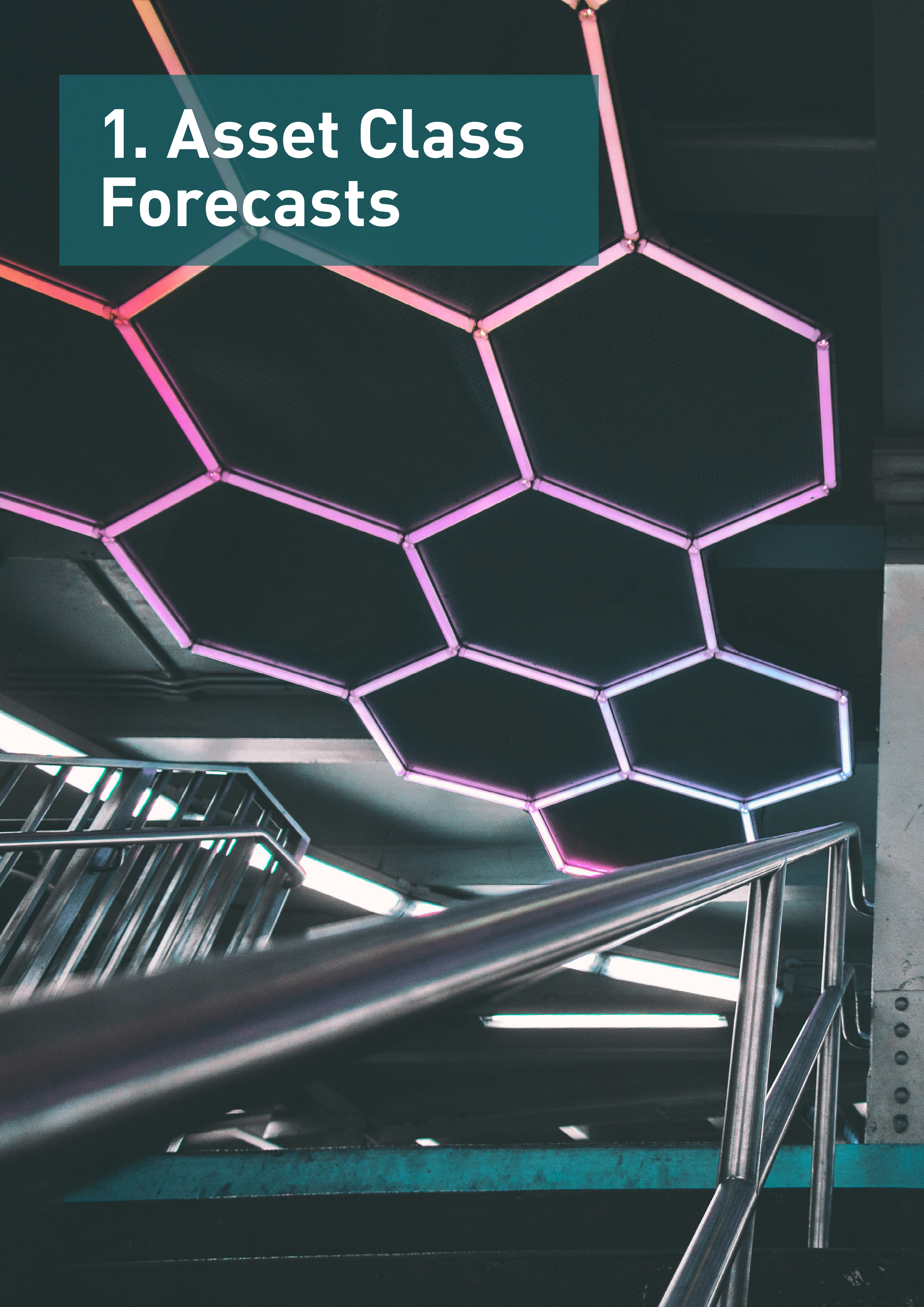
	2020	2025	CAGR
Private Equity	1,259	4,363	28.2%
Private Debt	60	155	21.2%
Hedge Funds	118	83	-6.8%
Real Estate	108	125	3.0%
Infrastructure	73	246	27.6%
Natural Resources	2	1	-2.2%

Diversified Multi-Regional-Based Assets under Management ($bn)



	2020	2025	CAGR
Private Equity	39	38	-0.4%
Private Debt	13	37	24.0%
Hedge Funds	0	0	0.0%
Real Estate	2	1	-9.3%
Infrastructure	29	200	47.4%
Natural Resources	11	50	33.8%

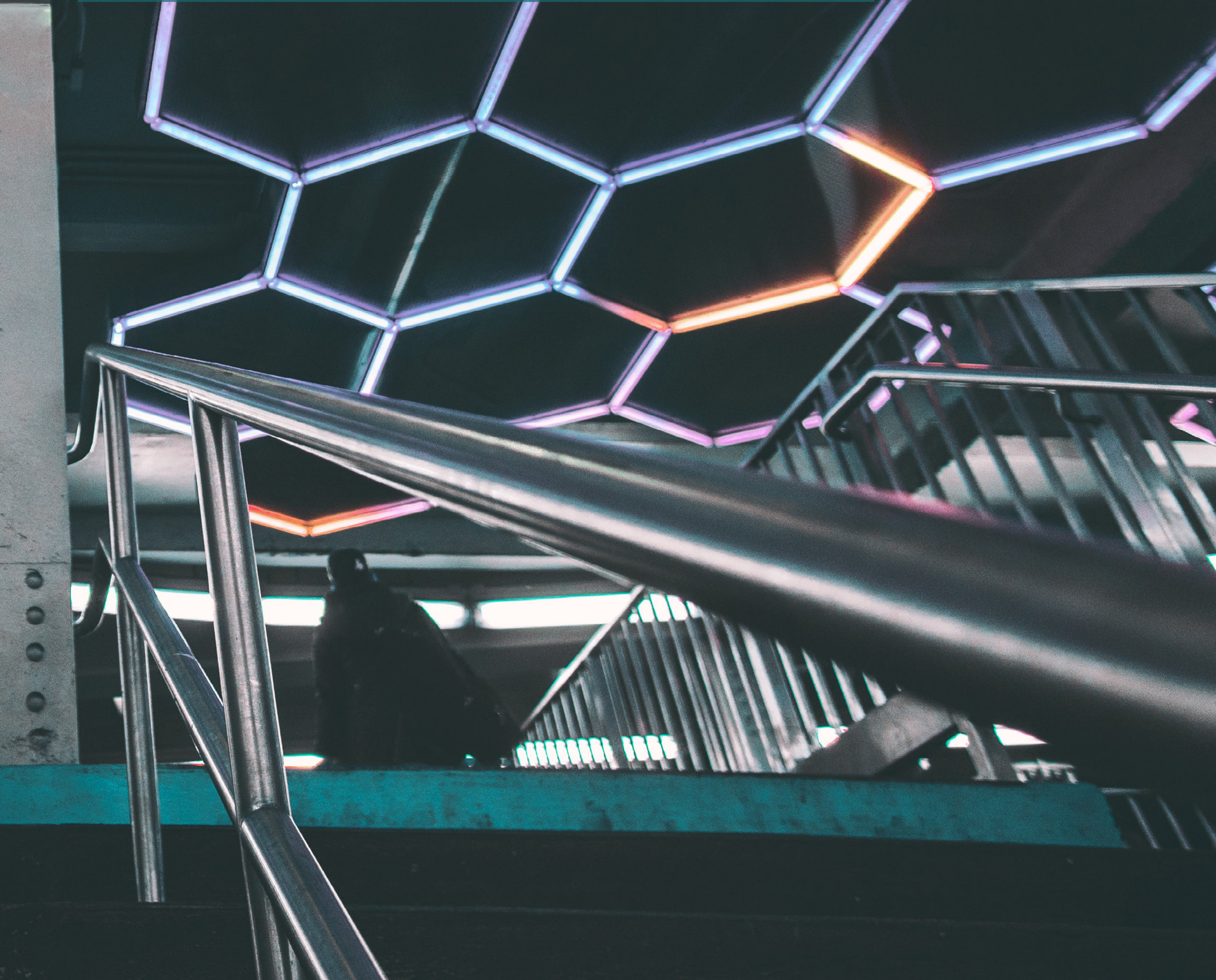
1. Asset Class Forecasts



Alternatives AUM is predicted to rise from **$10.74tn** in 2020 to **$17.16tn** in 2025; the forecasted CAGR of **9.8%** is lower than the **10.3%** recorded from 2010 to 2019

Private equity will be the fastest-growing asset class, with **15.6%** growth in AUM through 2025, rising from **$4.42tn** in 2010 to **$9.11tn**

Private debt AUM will increase from **$848bn** to **$1.46tn**, at a CAGR of **11.4%**, as investors seek alternative sources of yield



Preqin Forecasts Alternative AUM Growth of 9.8% through to 2025

Using a range of linear models, we predict which asset classes will enjoy the fastest growth over the next five years

Preqin's AUM forecast model utilizes a range of sub-models to achieve its outputs, with the impact of the COVID-19 pandemic reflected in the forecast data. The model points to significant growth in global AUM across all alternative asset classes. Between the end of 2020 and the end of 2025, global AUM in alternatives is expected to increase by 60%, equal to a CAGR of 9.8% (Fig. 1.1). The rate of growth should far outpace global GDP and inflation, with significant real appreciation across the alternative assets space.

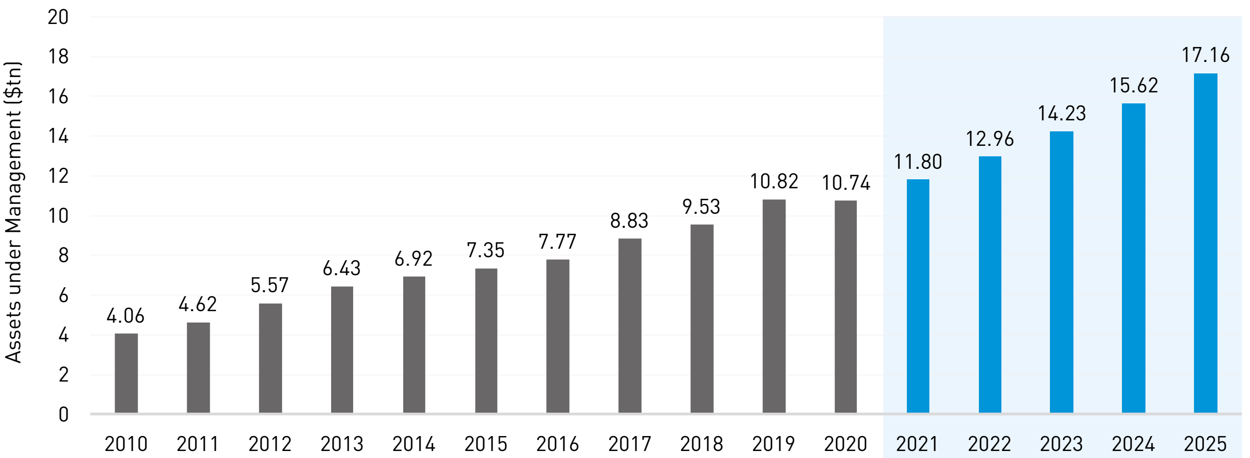
The distribution of this growth will not be even. Private equity and private debt assets are set to grow by 15.6% and 11.4% per year, respectively. At the other end of the scale, all other asset classes are expected to grow at a rate of 5% per year or less.

The bulk of AUM growth in private markets is expected to take place in Asia-Pacific, where we predict AUM will swell from $1.62tn in 2020 to $4.97tn in 2025. The twin factors of lower penetration rates and faster GDP growth than more established markets in the US and Europe will attract significant interest from both investors and fund managers.

We expect AUM growth to be strongest in the private equity market. Private equity assets have displayed their resilience during times of economic stress and have generated returns superior to other asset classes. With the market less mature in fast-growing Asia, a large proportion of the market growth will come from that region.

Private debt AUM growth is not far behind that of private equity. The asset class is likely to be buoyed by

Fig. 1.1: Alternative Assets under Management and Forecast, 2010 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

the global hunt for yield in an era of 'lower for longer' interest rates – the phrase may have been overused in recent years, but that does not make it less true. With many government bond yields in negative territory, and some corporate bonds following a similar path, long-term investors that need to match income with liabilities are likely to drive demand for assets with steady income streams. Private debt funds have performed exceptionally well, delivering a horizon IRR of 8.8% in the 10 years to December 2019, according to Preqin Pro.

Methodology

Preqin's AUM forecasts are the results of internal collaboration between our dedicated Data Science and Research Insights teams.

The Preqin dataset includes historical AUM across asset classes and geographies, as well as fundraising and deals. This data was overlaid with historical time series for a range of macroeconomic data, such as GDP, inflation, and central bank policy rates across major global economies including the US, UK, the eurozone, China, and Japan. Various modeling techniques were explored in order to select the methodology most appropriate to the dataset. Ultimately, an ensemble of linear models, with adjustments based upon experience within the Data Science and Research Insights teams, was selected. Adjustment was included to account for the conservative estimates of the model, compared to challenger models.

We will continue to develop this model, with future iterations expected to highlight a range of potential sensitivities, allowing users to amend the various inputs and produce their own forecasts.

We call Preqin 'The Home of Alternatives.' Since 2003 we've worked to improve transparency within the industry, which we believe has helped attract investors and, ultimately, direct finance and expertise to the companies that need it. We are proud to be part of the alternatives ecosystem and look forward to an exciting five years of growth

Mark O'Hare
CEO
Preqin

Private Equity AUM Will Top $9tn in 2025

Private equity and venture capital funds will fly higher as institutional investors continue to turn away from actively managed public equity funds

There appears to be no stopping private equity & venture capital (PEVC). Preqin's forecast is for AUM to more than double from $4.41tn at the end of 2020 to $9.11tn in 2025 (Fig. 1.2), despite a pause in growth in 2020 caused by the coronavirus pandemic. We expect strong performance and net inflows into the asset class to drive a global growth rate of 15.6% over the period.

We expect investors to continue a gradual rotation out of actively managed public equity funds into passive instruments and private equity. PEVC will extend its position as the dominant asset class within the alternatives space, with private debt the second fastest-growing asset class. We predict that PEVC will swallow an even larger share of the alternatives pie, with its proportion of alternatives AUM rising from 42% in 2019 to 53% in 2025. Low interest rates will continue to support the financing of buyout funds, providing markets can avoid any material financial stress that would limit lending.

Capital Concentration Set to Accelerate

COVID-19 has not dampened investor appetite for alternatives in the longer term. In Preqin's *Future of Alternatives 2025* survey, 23% of respondents expect to significantly increase allocations to private equity by 2025, with a further 56% planning a slight increase. Just 4% of respondents were planning to decrease allocations.

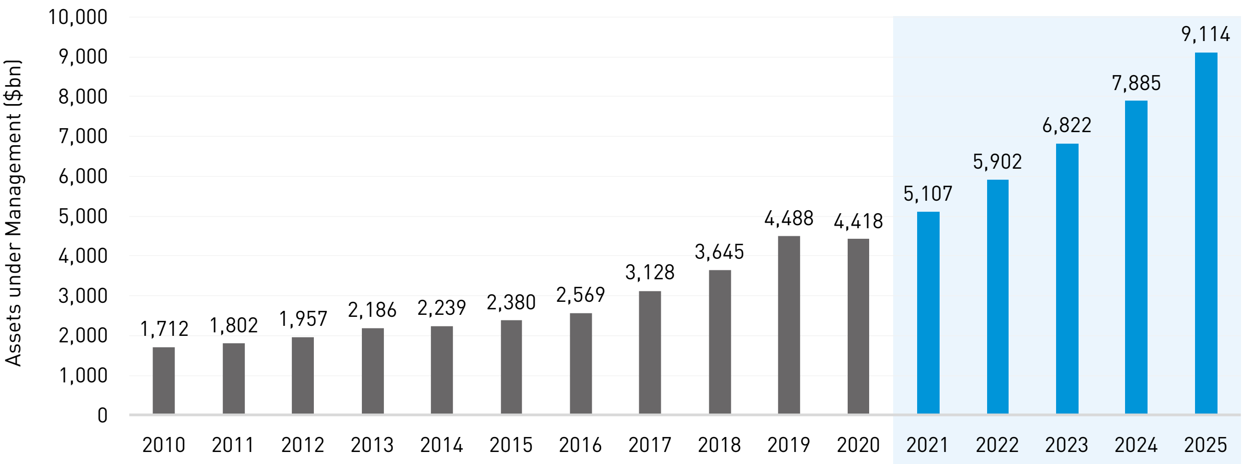
We expect this capital to flow into a smaller number of larger funds. This trend was well established going into the COVID-19 crisis: average buyout fund sizes increased from $765mn in 2017 to $1.3bn in 2019, while the annual number of funds closed dropped from 299 to 246. However, capital concentration does not mean that smaller managers will be left high and dry. A full 79% of investors in our survey expect to increase their number of fund manager relationships over the next five years.

The pandemic has also helped accelerate a number of industry-specific trends that GPs are likely to remain focused on. E-commerce, online grocery, and EdTech are just some examples of industries that will see an accelerated increase in market share in the post-pandemic environment.

Can Valuations Push Higher Still?

A powerful driver of past performance has been the ever-expanding earnings multiples assigned to

Fig. 1.2: Private Equity Assets under Management and Forecast, 2010 - 2025*



2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.

Source: Preqin

deals – and there has never been a boom that hasn't ended. However, in this environment of easy monetary conditions, and strengthening flows of capital into the market as investors search for returns, who would bet against still higher valuations? For fund managers, valuations cut both ways: 43% of survey respondents feel valuations over the next five years will have a positive impact on their business, against 29% that see them as a negative (Fig. 1.3).

Barriers to trade, the geopolitical landscape, regulation, and domestic politics were seen as the most negative forces in the PEVC market over the coming five years, while access to talent, the exit environment, and interest rates were seen as positives. Going forward, we also expect funds to continue adopting increasingly sophisticated techniques to raise the leverage of funds. Key to this will likely be a wider use of subscription financing, which allows GPs to deploy capital before it is called from investors, effectively leveraging returns.

Asia Set to Light up Global Private Equity

Ongoing developments in capital markets in China are expected to lead to rapid growth in the PEVC industry in Asia-Pacific over the next five years. China's growth comes as it continues to move away from more opaque financial products in the shadow financial system and toward a more formalized investment industry. However, the extent of cross-border GP-LP flows may be curbed in both directions if international relations between the US and China continue to deteriorate.

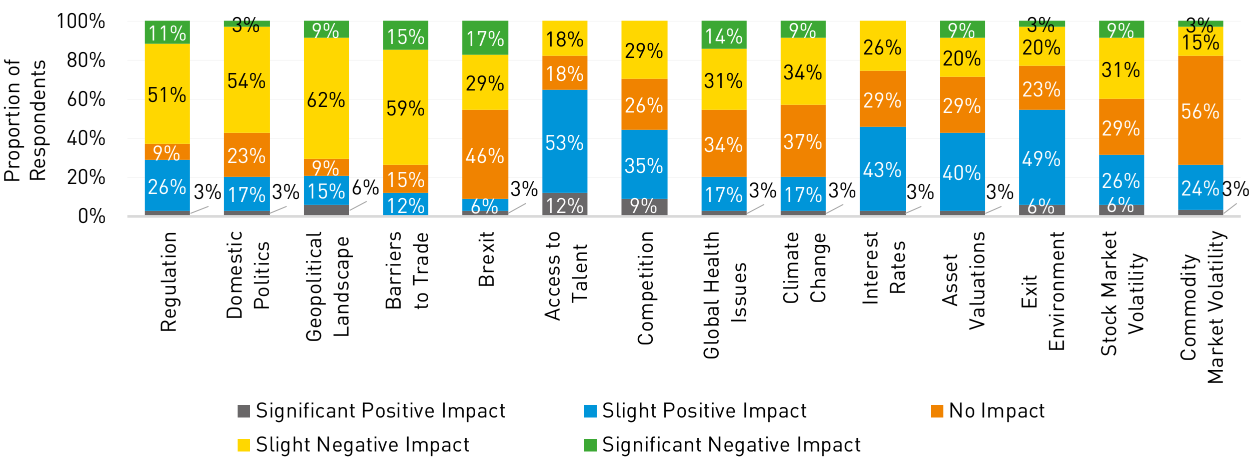
Specialization will be table stakes for venture and private equity over the next five years. Given the abundance of available capital, entrepreneurs insist on pragmatic collaboration from their investment partners to help them scale without impeding their hyper-growth trajectory

Joe Kaiser
Director
Mercato Partners

Our investment returns don't come from trying to squeeze a turn or two out of an entry multiple, but from making sure we identify the very best opportunities where we can work closely with management teams to drive 'above plan' business performance

David Toms
Head of Research
Hg

Fig. 1.3: Private Equity Fund Manager Views on How Stimuli Will Impact Their Business over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

Private Debt's Spectacular Rise Will Continue

Investors' ongoing search for yield has put private debt in their sights. With further growth expected in Europe and emerging markets, we predict the asset class will be the second fastest-growing alternative, hitting $1.46tn in 2025

Private debt will continue the expansion of the past decade over the next five years. Total AUM has risen 168% from $315bn in 2010 to $845bn in 2019, and Preqin expects this growth to continue with a 73% increase in AUM to $1.46tn by 2025 (Fig. 1.4).

A third of all private fund managers surveyed by Preqin for *Future of Alternatives 2025* believe banks will be less or significantly less important as debt lenders over the next five years, compared to a quarter that expect them to be more important (Fig. 1.5). A substantial majority (62%) of respondents expect private debt funds to play a bigger role, with just 4% saying they will be less important.

An Attractive Prospect for Yield-Hungry Investors

Of the private debt investors surveyed by Preqin, 58% intend to increase allocations to the asset class by 2025, with only 7% expecting allocations to decrease (Fig. 1.6). Preqin data shows a horizon IRR of 8.8% over the 10 years to 2019 – and this strong historical performance may be difficult to match. Of surveyed private debt fund managers, 49% expect lending terms to improve over the coming five years, compared to 24% that expect a deterioration.

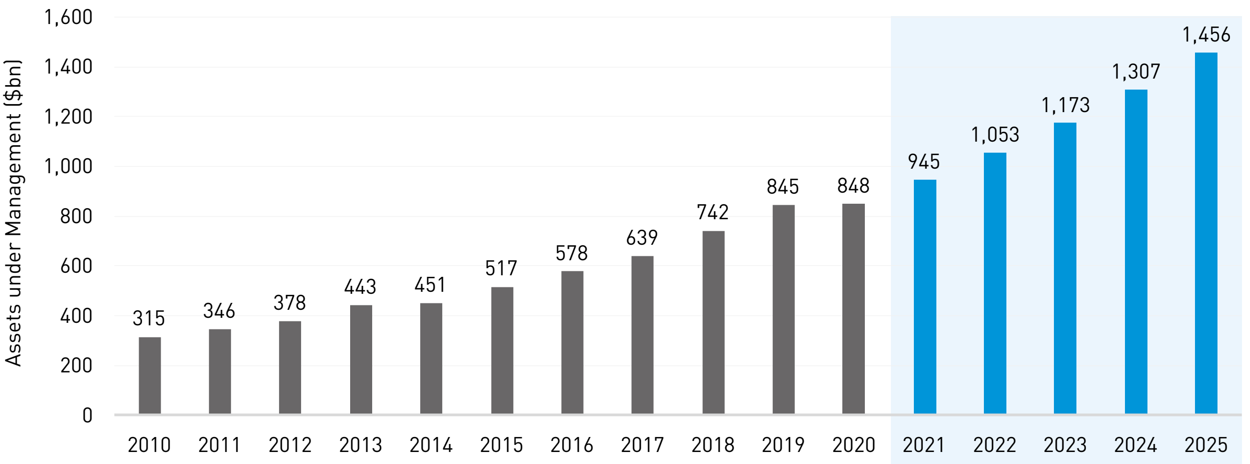
Emerging Markets Are Coming into Play

While the US has long been the global hub of private debt activity, Europe is catching up. Private debt AUM in Europe has grown by 380% over the past 10 years, and now constitutes just over 20% of total AUM for the asset class.

The Asian private debt market has taken off in recent years. Small and mid-sized companies, which account for two-thirds of jobs in the region, faced an annual funding gap of over $4tn in 2019.[1] Twenty-three percent of surveyed fund managers believe emerging markets currently present the best opportunities, but 39% predict they will offer the best opportunities in five years' time.

[1] *https://www.asianinvestor.net/article/asias-4tr-funding-gap-luring-private-debt-investors/463296*

Fig. 1.4: Private Debt Assets under Management and Forecast, 2010 - 2025*



2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.

Source: Preqin

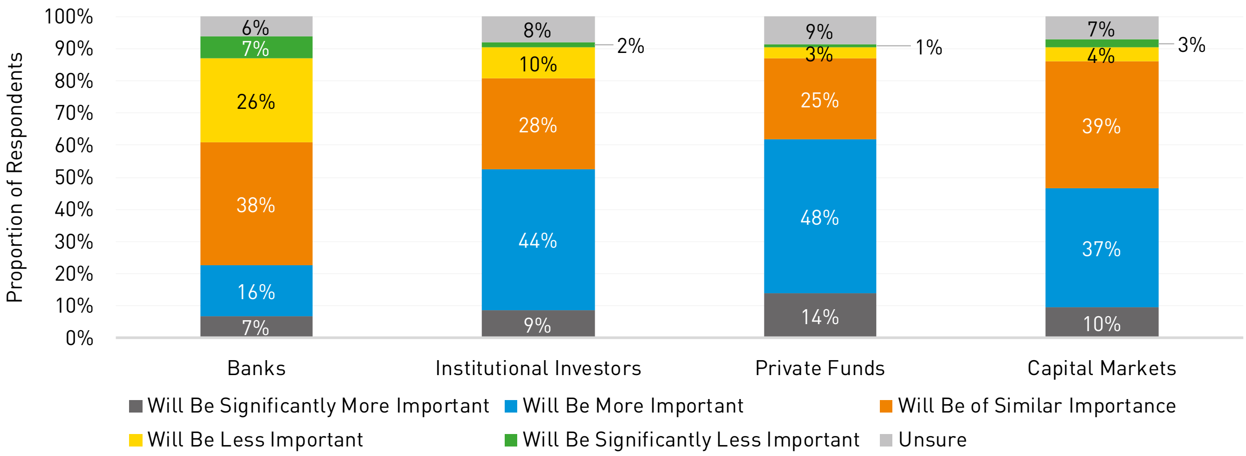
> **We believe returns from private debt will track above those in the liquid fixed income markets. In the context of the 'search for yield' across asset classes, we expect the environment for private debt to remain favorable for the foreseeable future**

Anthony Fobel
CEO
Arcmont Asset Management

> **We see the big private debt asset managers diversifying into providing minority equity alongside senior debt. At the other end of the spectrum, you'll see direct lenders having to focus on specific specializations or sectors**

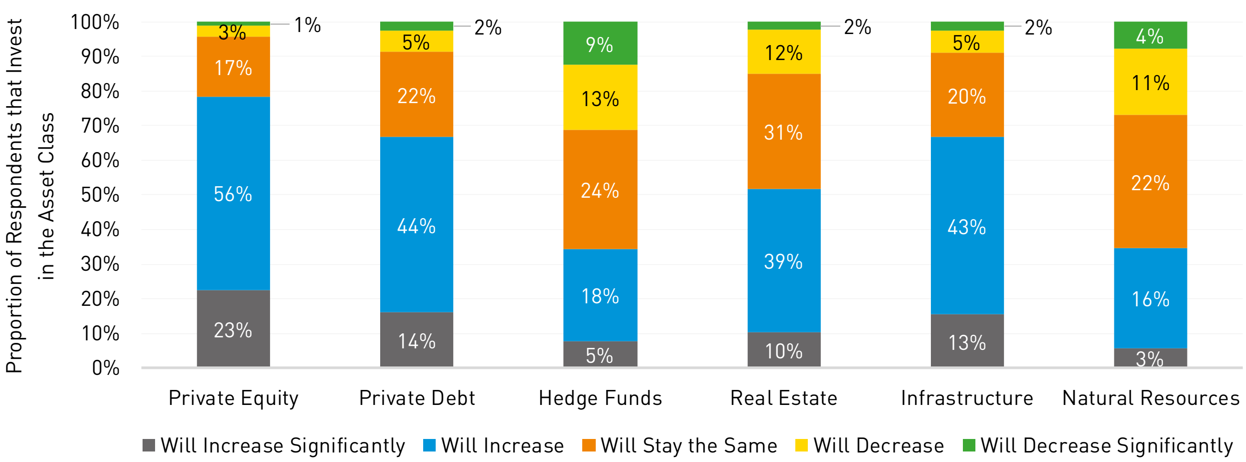
Fenton Burgin
Head of UK Advisory Corporate Finance
Deloitte

Fig. 1.5: Fund Manager Views on the Importance of Debt Lenders in the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

Fig. 1.6: Investors' Plans for Their Allocation to Alternatives by 2025 by Asset Class



Source: Preqin Investor Survey, August 2020

Make Way for Mezzanine in Africa and the Middle East

Private debt is new to the region, but Omar Rifai at Gulf Capital says a number of GPs are laying solid foundations for future growth in the asset class, putting their faith in carefully structured deals

Across Africa and the Middle East, mezzanine debt is emerging as a compelling way to invest in fast-growing lower-middle-market companies. We expect private debt to play a big role in private capital markets over the next five years.

While private equity has many attractions, shareholders of many fast-growing lower-middle-market companies that reach $5-10mn in EBITDA are unable or unwilling to take on dilutive capital due to a difference in valuation expectations or private equity's increasing focus on acquiring controlling stakes. Many shareholders are also unwilling to underwrite an exit for private equity firms through put options and drag rights.

Gulf Capital has been investing in growth capital in the Middle East and Africa through traditional mezzanine debt, convertible debt, and preferred equity in healthcare, business services, industrials, and TMT since 2012.

An Attractive Profile

The value proposition is compelling. LPs can target mid-teen IRRs on an unleveraged basis, a high single-digit cash yield, reasonably low leverage on the underlying asset, and ample protection and rights. Mezzanine managers in the region are developing their track records and a learning curve, mainly in the form of sector selection and structuring, attracting increased interest from investors. Mezzanine offers a way to diversify risk and allocate private capital to growing markets that is complementary to private equity.

Omar Rifai
Managing Director

Gulf Capital
www.gulfcapital.com

Omar Rifai is a Managing Director in the private debt team at Gulf Capital, one of the leading alternative asset management firms in growth markets, investing across private equity, private debt, and real estate. It currently manages over AED 11bn ($2.5bn) across seven funds and investment vehicles. Gulf Capital's mission is to grow capital and build value with world-class expertise and best practices to generate sustainable superior performance for all stakeholders.

We have been particularly successful backing companies at a clear inflection point, fueling their growth ahead of an ultimate sale to strategic and financial investors or a stock market listing. Gulf Capital's investment in Amana Healthcare, a leading network of rehabilitation clinics in the UAE, fueled rapid expansion culminating in a strategic sale to Mubadala (see Case Study).

We also invested in ADES, a leading oil & gas drilling company in Egypt, funding the acquisition of competitors and expansion across the GCC and North Africa. ADES became the clear leader across MENA and completed an IPO on the London Stock Exchange in 2017.

Adapting Private Debt to Emerging Markets

In emerging markets, the lines in the capital structure can easily be blurred. Our markets are more susceptible to long macroeconomic cycles and often lack clear credit protection laws. This creates a natural barrier where competition is limited, as experience and familiarity in navigating local markets are key to success.

Having invested in 16 companies operating in 10 jurisdictions across Africa and the Middle East since 2012, we have established a framework to understand how to structure mezzanine investments in our markets. Clearly defined investment criteria, sector focus, structuring, and the ability to assess unintended equity risk are critical to generating attractive returns. A hands-on, private equity approach to due diligence and portfolio management is important. Across our portfolio, the decision by shareholders to take on less dilutive growth capital paid off for the company, while our investors benefited from high double-digit IRRs, a great cash yield, and downside credit protection.

Case Study

Amana was established in 2012 as a provider of inpatient rehabilitation, long-term care, and home healthcare in the UAE. In 2014 Gulf Capital provided a bespoke and secured mezzanine facility that funded the establishment of Amana's second rehabilitation center in Abu Dhabi and facilitated a share buyback.

The deal structure highlights the flexibility GPs need to help establish private debt in the region. Gulf Capital's investment included an upside sharing mechanism, while a hands-on approach led to improvements in corporate governance, financial reporting, and debt-raising capabilities. Mubadala's healthcare division acquired Amana in 2018.

Hedge Fund Industry Growth Will Be Reduced by Outflows to 2025

Hedge fund AUM is forecast to increase 19.6% from 2020 to 2025, at a CAGR of 3.6%, but performance-driven growth will be diluted by investor outflows

We expect hedge funds to hold onto their position as the second-largest alternative asset class in 2025, despite relatively weak growth in AUM due to continued outflows. AUM growth will be the lowest of all asset classes at a CAGR of 3.6% per year. Preqin forecasts AUM to reach $4.28tn in 2025, up 19.6% from $3.58tn at the end of 2020 (Fig. 1.7).

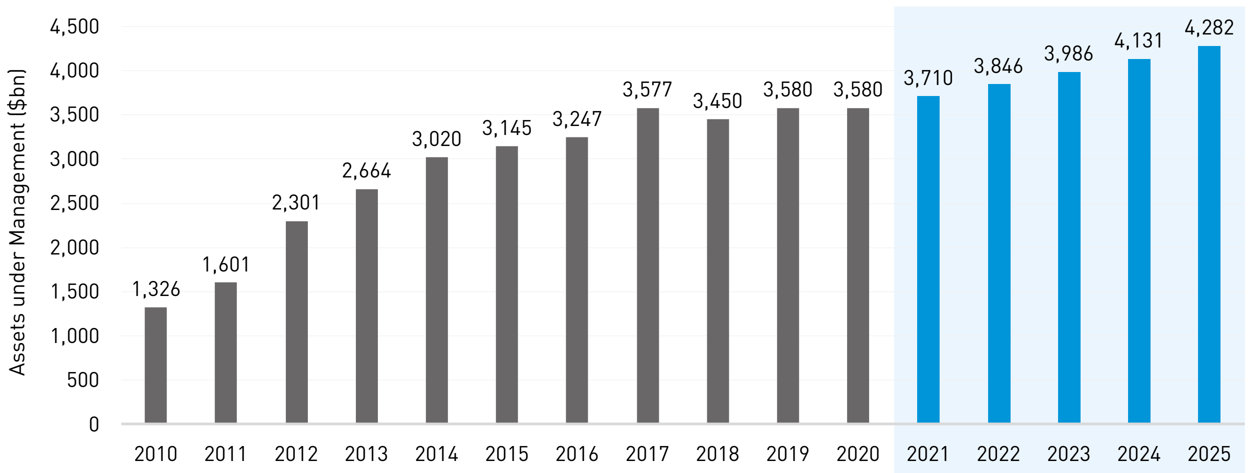
Our prediction is that hedge funds will lose out to passive exchange-traded funds (ETFs), smart beta, and other liquid alternatives that offer risk-adjusted returns at lower cost. We expect AUM to be boosted by performance, with hedge fund returns beating the AUM growth rate over the next five years. The Preqin All-Strategies Hedge Fund benchmark posted an average yearly return of +6.27% from 2015 to 2019.

Active Managers Will Continue to Perform Well in Volatility

Hedge funds have the potential to shine in a period with higher-than-average volatility, which has so far defined 2020. The next five years look likely to pose more economic and financial market risks than the past decade. The COVID-19 crisis has necessitated changes that will increase market volatility for years, such as increased debt loads of companies, central banks, and countries, while political risks also lie ahead as countries rethink trade policy and secularization.

We expect macro and equity strategies to remain the largest strategies in terms of AUM. Fig. 1.9 shows that long/short equity and macro funds together make up over a third of core strategies targeted by investors in the next 12 months.

Fig. 1.7: Hedge Fund Assets under Management and Forecast, 2010 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

Although a relatively small component of the hedge fund universe, cryptocurrency and related digital asset infrastructure hedge funds doubled in AUM between 2018 and 2019, according to a PwC and Elwood survey[1], and are expected to do the same by the end of 2020. We expect existing hedge fund strategies to augment investment operations with cryptocurrency trading, following the lead of macro and quant strategies which were early adopters.

Hedge Funds Will Open up to Retail Investors

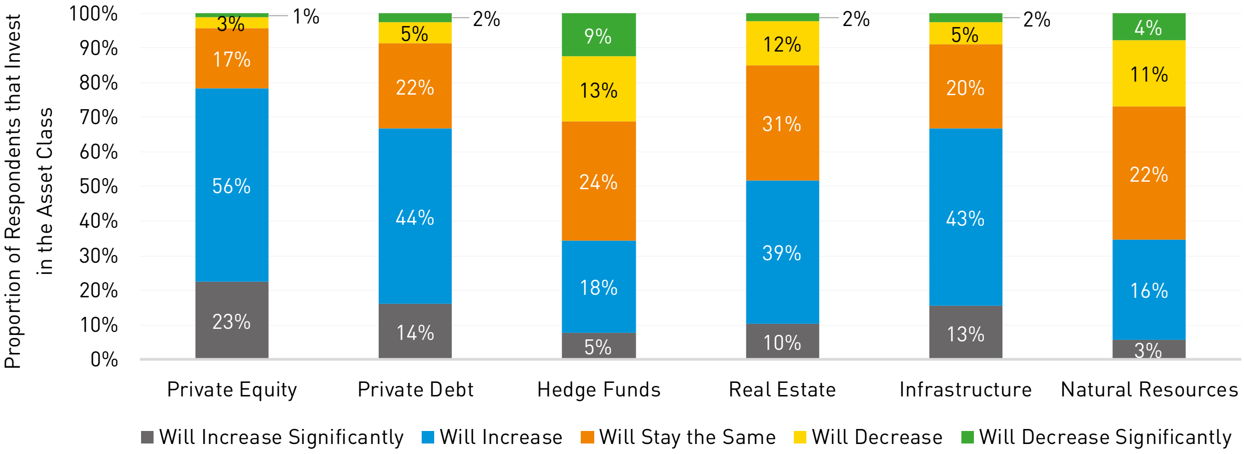
The regulatory landscape is becoming more favorable to allowing retail investor inflows to the asset class. The SEC recently expanded its definition of an accredited investor[2], which could be the first step toward retail participation in the asset class. Regardless of such changes, institutional investors will continue to control the vast majority of AUM.

Alternative asset managers are well placed to deliver double bottom-line benefits: superior investment returns by doing good socially and environmentally while actively encouraging high standards of governance

Tom Kehoe
Managing Director
AIMA

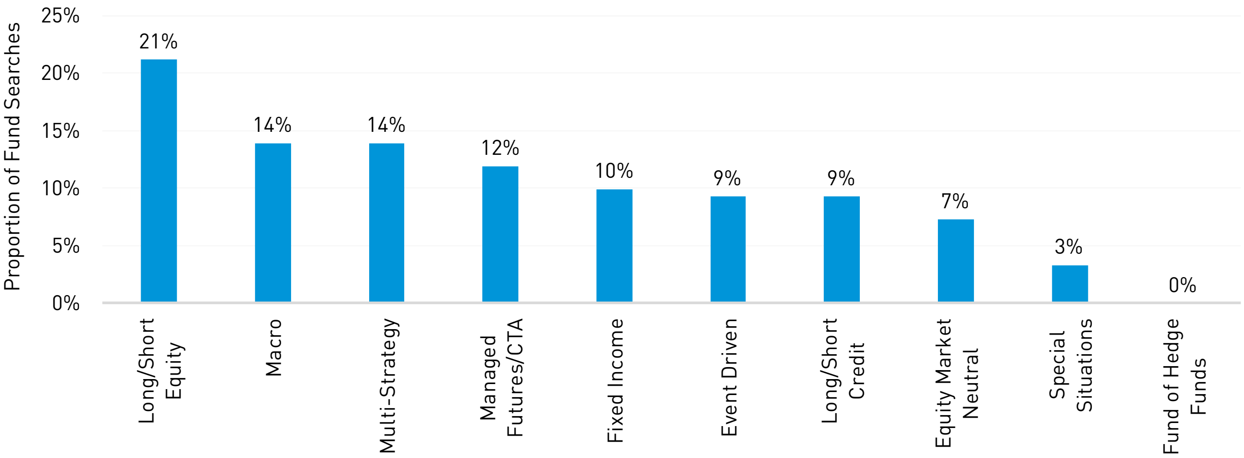
[1] *https://www.pwc.com/gx/en/financial-services/pdf/pwc-elwood-annual-crypto-hedge-fund-report-may-2020.pdf*
[2] *https://www.sec.gov/news/press-release/2020-191*

Fig. 1.8: Investors' Plans for Their Allocation to Alternatives by 2025 by Asset Class



Source: Preqin Fund Manager Survey, August 2020

Fig. 1.9: Core Strategies Targeted by Hedge Fund Investors over the Next 12 Months



Source: Preqin Pro

Hedge Funds: Embrace, Adapt, Prosper

As ESG and digital technologies transform the hedge fund industry, Tom Kehoe of AIMA says it's only by tackling these issues head on that managers will earn a bigger slice of the allocation pie

What does the future hold for the hedge fund industry, given its history of innovation? What kind of products will funds deliver to their investors? How will they reconcile profits with social responsibility? Will hedge funds as we know them even exist, or will they be replaced by machines?

The recent disruption has shown the industry to be highly adaptable and resilient in the face of massive market disruption. We are in the middle of an evolution where hedge funds that innovate and are flexible will become asset managers that succeed and grow. Looking out over the next five years, two significant thematic trends will dominate the outlook for the industry.

Funds Must Embrace Change

Efforts to integrate ESG across investment products will intensify, led by demand from investors and requirements by policymakers. Out of this disruption, we expect to see increased interest in strategies that incorporate ESG and sustainable finance considerations. Sustainability, climate change, and social concerns are now considered core risks and objectives by asset managers and allocators. At AIMA, we strongly believe that alternative asset managers are well placed to deliver double bottom-line benefits: superior investment returns by doing good socially and environmentally, while actively encouraging high standards of governance.

The second mega trend is technology. Every industry in the world is being disrupted or will soon face disruption by technology. The advent of cutting-edge statistical and computational tools is increasingly pushing the hedge fund industry toward a more quantitative outlook. Over the coming years, machine

Tom Kehoe
Global Head of Research & Communications

AIMA
www.aima.org

The **Alternative Investment Management Association (AIMA)** is the global representative of the alternative investment industry, with more than 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2tn in hedge fund or private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400bn of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

learning and the use of alternative data will become steadily more important for hedge fund firms until it becomes a necessity.

One thing will remain constant: the success of a hedge fund firm depends on the quality of its most critical asset – its people. Fostering diversity and inclusion is an imperative for all businesses, hedge funds included. Allowing greater innovation and a wider variety of voices to be heard will result in better decisions being made and better investment outcomes.

The industry will continue to grow because hedge funds still provide the opportunity to source differentiated investment exposure with non-correlated returns. A major rethink on portfolio allocation must surely see alternative investments play a greater role in investor preference, with hedge fund investing being more prominent.

AUM Growth of 3.4% a Year Will Not Lift All Real Estate Segments

Investors seeking yield will turn further toward real estate assets, while funds promising higher returns will be pushed up the risk curve

Lower for longer. Almost the entire way through the post-GFC economic cycle, interest rate calls have been revised downwards, or expectations of higher interest rates pushed well into the future. With COVID-19, that future looks even further away, if – a big if, given the liquidity pumped into the system – inflation is kept in check.

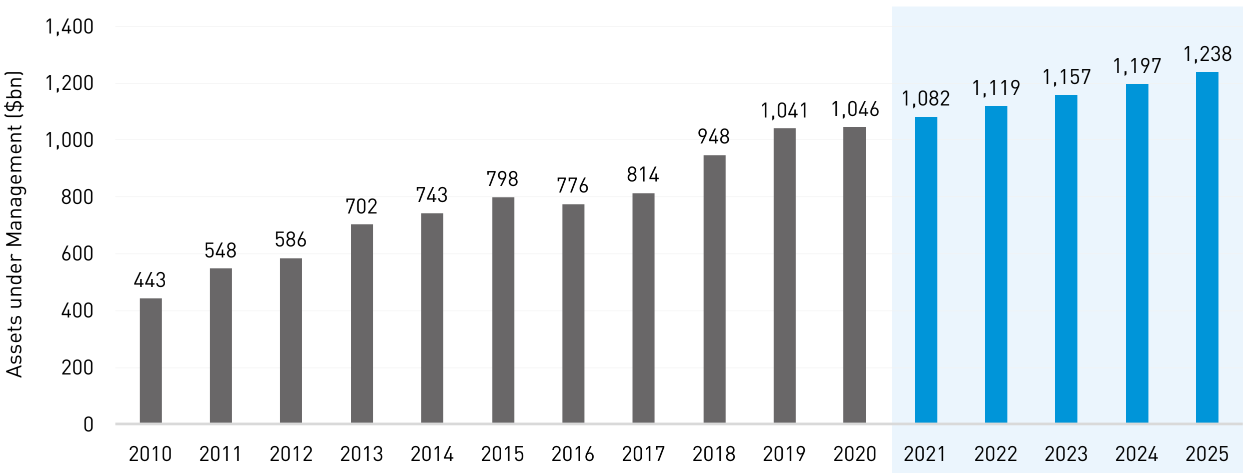
What does this mean for real estate? Preqin's Future of Alternatives forecast is that private real estate AUM will grow from $1.05tn in 2020 to $1.24tn in 2025 (Fig. 1.10). While lower than our CAGR forecast of 9.8% for all alternatives AUM, the real estate AUM growth of 3.4% per year should be viewed in the context of a market hit by what will likely be a period of demand uncertainty for its two largest asset classes: retail and offices.

Despite this, demand for real estate assets persists. Average allocations have risen from 7.0% in 2010 to 9.2% in 2019 for public funds and 6.2% to 7.1% for corporate pension funds. Family offices too have increased exposure, from 8% to 13% over the same period. Insurance companies, banks, government agencies, and foundations have been cutting back their allocations, while allocations at asset managers, endowment plans, sovereign wealth funds, superannuation schemes, and wealth managers have remained stable.

Real Estate Will Yield Results

Investors are likely to continue turning to real estate to provide yield they cannot secure from their fixed-income portfolio. Over the next few years, bond-like real estate investments may experience rising demand. These long-leased assets can benefit from strong

Fig. 1.10: Private Real Estate Assets under Management and Forecast, 2010 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

covenants, indexed rents, and stable cash flows, making them increasingly attractive to long-term investors or those seeking inflation protection.

Nearly half (49%) of real estate investors surveyed for *Future of Alternatives 2025* expect to increase their allocation to private real estate, with 10% planning a significant increase, a further 31% maintaining allocations, and just 12% expecting to invest less (Fig. 1.11). With the yield differential to government bonds at the forefront of investors' minds, there may be a desire to enter new markets, where yields achievable from Grade A or prime assets are higher than in more established locations.

Taking Risks to Generate Returns

Real estate allocations do not only target income. Returns can be boosted by moving up the risk curve, with development and large-scale refurbishment of assets a potentially more attractive future strategy. Owners of poorer-quality offices, or those in secondary locations away from transport hubs, may be exposed to more downside risk in future years than they have been recently.

COVID-19 will have a lasting impact on demand for space, but while fewer people will be working solely in an office, more space per person will be needed when people are mixing more closely together. Offices without collaboration space or quality video conferencing suites may lose out to new developments or heavy refurbishments. An added benefit for occupiers in newer buildings will be increased efficiency in heating and ventilation, boosting commitments to ESG practices.

[1] *https://www.ft.com/content/5106488e-0618-47de-9307-642501beab7f*

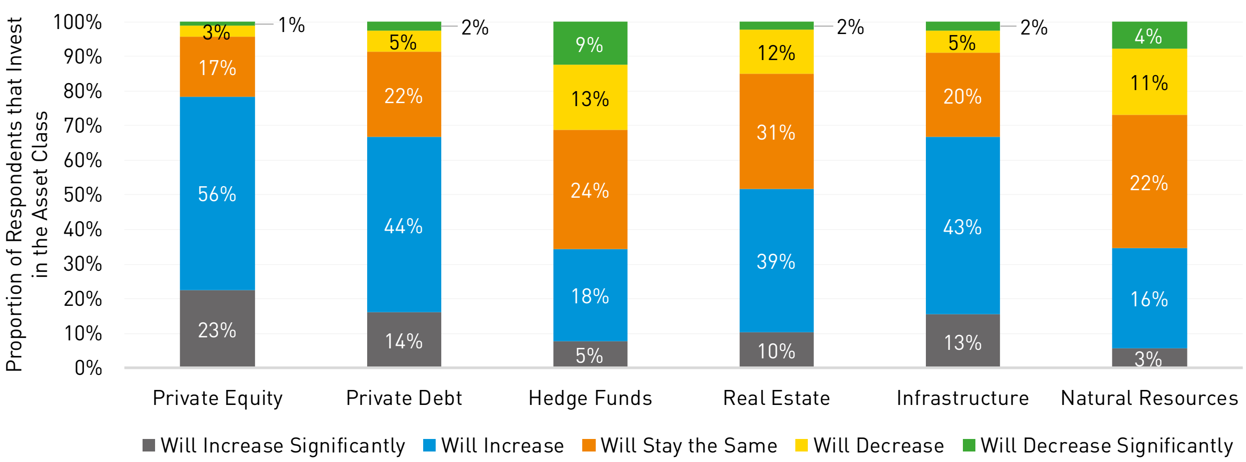
While offices may be subject to a wide range of threats and resultant opportunities, retail assets are likely to be laggards. Increased vacancy, lower footfall, the rise in online shopping[1], and growing acceptance that shops may not be the driver of online activity that was previously expected, will hit the sector hard. Each of the issues listed could have a negative impact individually, but when combined they could result in major changes to the way retailers view their estate and how investors price these assets.

It is unlikely that the real estate sector will evolve in a linear way over the next five years. We expect the gaps between the winners and losers to widen.

Real estate allocations do not only target income. Returns can be boosted by moving up the risk curve, with development and large-scale refurbishment of assets a potentially more attractive future strategy

Dave Lowery
Head of Research Insights
Preqin

Fig. 1.11: Investors' Plans for Their Allocation to Alternatives by 2025 by Asset Class



Source: Preqin Fund Manager Survey, August 2020

Laying the Foundations for Infrastructure Growth

The attractions of infrastructure for many investors will push capital to the asset class, with AUM in private vehicles predicted to rise by 25% to $795bn in 2025

Facing the prospect of recessions unprecedented in scale, governments have delivered economic stimulus packages never before seen in their scope, size, and speed. While we can but hope that COVID-19 is a short-term challenge, these expansionary fiscal policies have long-term implications.

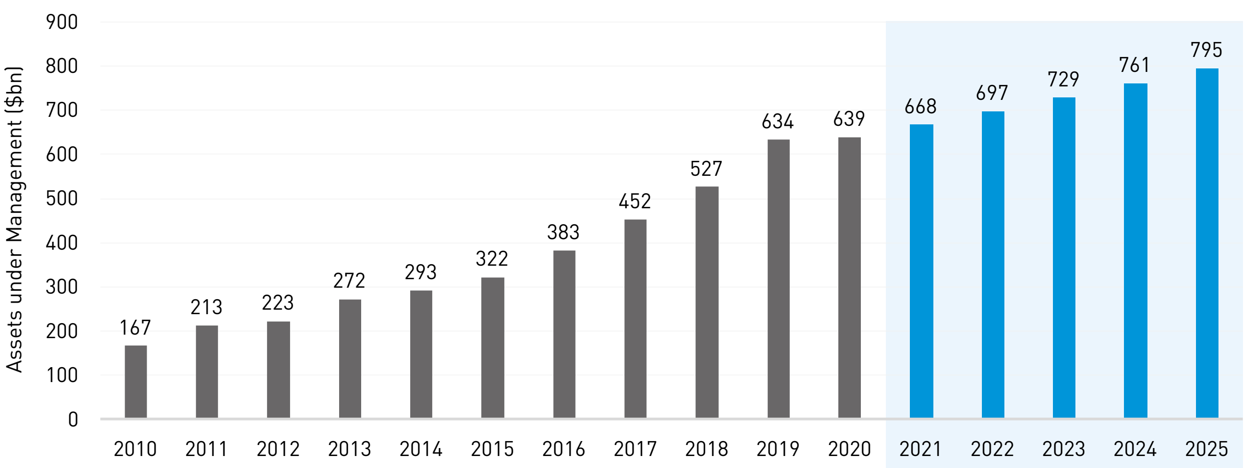
In the UK, public debt increased over 10% relative to GDP between March and July 2020, going above 100% of GDP for the first time since the early 1960s. US public debt passed the symbolic 100% mark in 2012 and climbed to 106% by the end of 2019, though is now expected to hit 120% by the end of 2020[1] and 125% a year later, according to Trading Economics. While fiscal sustainability ambitions have been dashed, longer-term constraints demand reassessments on how to finance and fund infrastructure investment programs. There is increasing recognition of the role infrastructure investment plays as a driver of economic growth. Large-scale capital investments provide short-run demand stimulus, in part from the labor intensity of construction works[2], as well as longer-run supply-side benefits[3], reducing business costs and promoting trade domestically and internationally.

Private Capital Will Play its Part

Private capital has a crucial role to play in filtering projects that will increase supply-side productivity through bankable funding models. Preqin forecasts that unlisted infrastructure AUM will grow at a CAGR of 4.5% from $639bn in 2020 to $795bn in 2025 (Fig. 1.12).

[1] *https://tradingeconomics.com/united-states/forecast*
[2] *https://www.cbi.org.uk/articles/fine-margins-delivering-financial-sustainability-in-uk-construction-bv/*
[3] *https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores093014a*

Fig. 1.12: Unlisted Infrastructure Assets under Management and Forecast, 2010 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

Among infrastructure investors surveyed by Preqin for *Future of Alternatives 2025*, 56% expect to increase their allocations to infrastructure in the next five years, with just 7% expecting to lower allocations. Pooled vehicles will account for the bulk of the increase, with 59% of investors intending to use this route more and 36% the same amount, followed by co-investment, which 48% of investors expect to do more of. Dry powder's share of AUM fell from 42% in 2010 to 35% at the end of 2019, a testament to fund managers' success at sourcing opportunities as the asset class has grown.

Many investors value the defensive characteristics of infrastructure. Contracted infrastructure assets have been an anchor in the storm in recent months, particularly when compared to other real assets such as real estate.

Superannuation schemes have held a long-term preference for infrastructure, with allocations staying above 5% for the past 10 years, reaching 6.3% in 2020, according to Preqin Pro. Public pension funds have increased their allocations to infrastructure, from an average of 2.1% in 2018 to 2.7% in 2020, in part reflecting a policy mandate to increase aggregate infrastructure investment. Private/corporate pension funds are holding steady on their allocations at 2.0% in 2020, though this will increase if their real estate and hedge fund allocations taper given recent sentiment (currently at 7.1% and 8.3% respectively). Banks have clearly signaled their recognition of the infrastructure asset class, with allocations holding steady at 2.0% in 2018, up from a mere 0.2% in 2015.

Infrastructure's Investment Gap

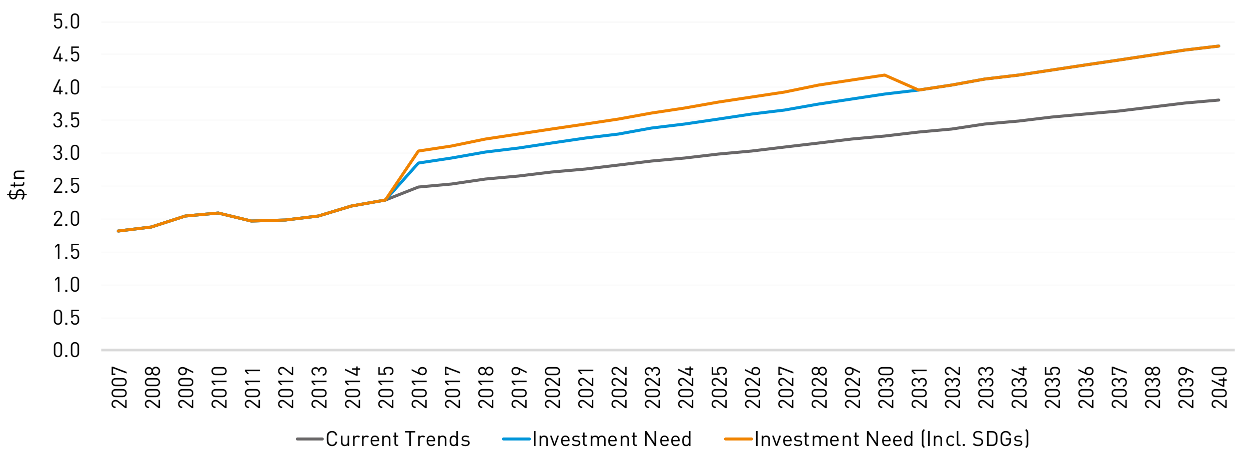
The G20 Global Infrastructure Hub[4] estimates an $18tn infrastructure investment gap out to 2040 to meet the Sustainable Development Goals (SDGs), against a projected spend of $79tn over the period (Fig. 1.13). Investment needs may increase far quicker if marginal gains in decarbonization become harder and more costly to achieve.

There is increasing recognition of the role infrastructure investment plays as a driver of economic growth. Large-scale capital investments provide short-run demand stimulus and longer-run supply-side benefits, reducing business costs and promoting trade domestically and internationally

Alex Murray PhD
VP, Research Insights
Preqin

[4] *https://outlook.gihub.org/*

Fig. 1.13: Infrastructure Investment at Current Trends and Need



Source: Global Infrastructure Hub

Seismic Changes Will Shake Natural Resources Investment

Despite AUM growing at a CAGR of 5.1% through to 2025, natural resources will remain an asset class for specialists – with innovation and ESG the keys to value creation

Energy has always dominated natural resources investment and will continue to do so in the future. However, as we look forward to 2025, changes to how energy is generated, stored, and used will disrupt the asset class and the wider world.

Preqin predicts unlisted natural resources AUM will hit $271bn in 2025 (Fig. 1.14). The projected 5.1% CAGR over the period is well below our 9.8% forecast for all alternatives, but higher than growth rates for real estate, hedge funds, and infrastructure.

Investors in natural resources have a steady commitment to the asset class. More than a fifth (22%) of natural resources investors surveyed for *Future of Alternatives 2025* do not expect allocations to change through to 2025, with the proportion planning to increase allocations (19%) a little larger than those looking to decrease (15%); roughly half of respondents will not invest in the class at all.

Carbon Reduction Targets Will Drive Investment

The 2016 Paris Agreement crystalized the commitments of governments globally to reducing carbon emissions. And these targets are only becoming more urgent, with the EU in talks about making its commitments to become carbon net neutral by 2050 legally binding. To achieve this, unprecedented investments in energy efficiency, renewable energy, and low-carbon technologies are required. Finding alternative energy sources where carbon-intensive forms are the only option given current technology, such as for air transport or maritime freight, is a challenge that will define whether 2050 targets are met.

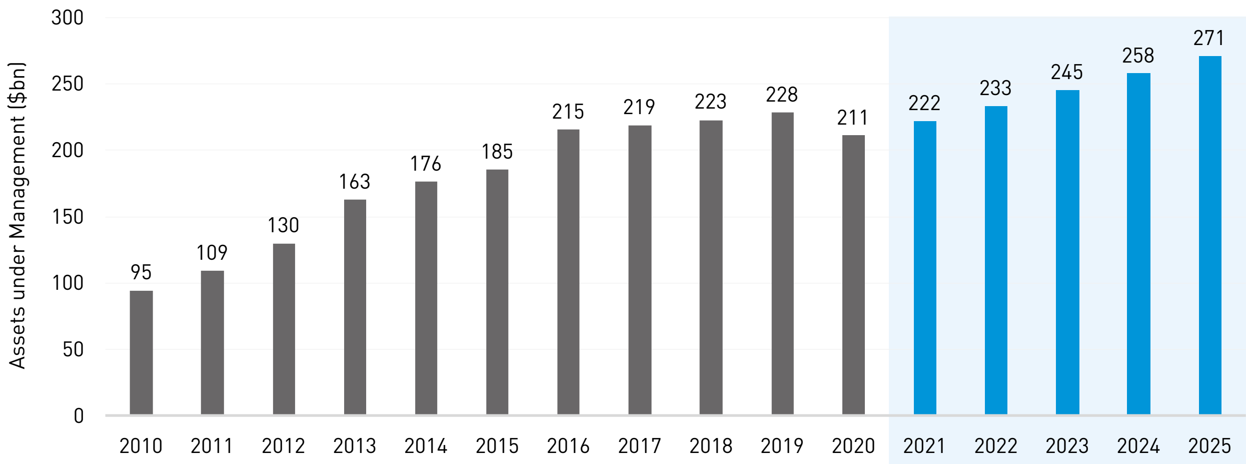
Renewables Will Fulfill Their Promise

The collapse of oil prices, particularly Brent oil futures, may indicate that we have passed peak oil. In fact, BP's 2020 Energy Outlook says oil demand could fall by as much 50%[1] over the next two decades.

The ability of renewable energy to meet growing levels of base-load demand, albeit in a period of reduced demand, has proved how credible renewable-only

[1] *https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/energy-economics/energy-outlook/bp-energy-outlook-2020.pdf*

Fig. 1.14: Unlisted Natural Resources Assets under Management and Forecast, 2010 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.* *Source: Preqin*

scenarios are and may lead to a shift in attitudes. In India, for example, the proportion of renewables grew[2] from 17.9% in March 2020 to 33% in August, while coal fell from 72.4% to 58.9% respectively. Investment in carbon-intensive generation is likely to continue in many developing economies for some years, though, despite the increased risk of stranded assets.

In the US, the coming expiry of PTC (wind) and ITC (solar) subsidies will be minimized when new initiatives are rolled out, such as the California Solar Mandate, which requires all new homes up to three stories high to have solar photovoltaic systems as an electricity source.

Technology and ESG Will Come to the Fore

Technology will drive investment in other areas of natural resources. In agriculture, for example, advances in farming technology are helping increase efficiency in the use of water, seeds, fertilizers, and pesticides, increasing yields and sustainability.

Fund managers will need to update their ESG policies as new threats emerge, from pesticide abuse to petrochemical fertilizer pollution, deforestation, and water responsibility. Falling asleep at the wheel can have disastrous effects: Rio Tinto CEO Jean-Sébastien Jacques was one of three senior executives to resign in September 2020 after an iron ore mining project destroyed an indigenous site.[3]

Investors are also increasingly concerned about the geopolitical landscape, which could have a particular impact on natural resources. A majority of surveyed fund managers (56%) think geopolitical issues will have a slightly (46%) or significantly (10%) negative impact on their business over the next five years, compared with 29% that hold a positive view (Fig. 1.15). Tensions between the US and China in particular are already impacting transactions, as seen with Israel's rejection of a $1.5bn water project by Hong Kong-based CK Hutchison Holdings.[4]

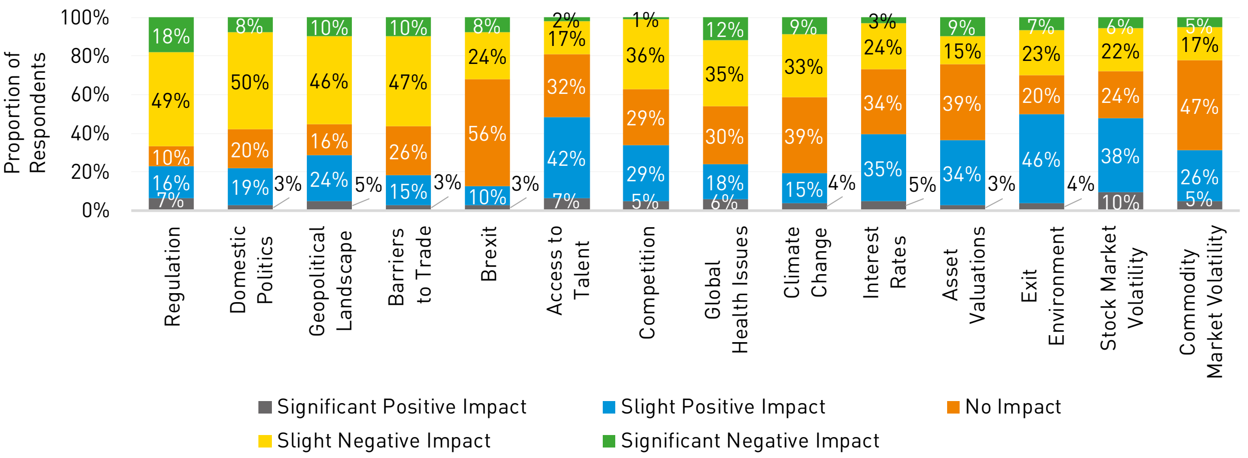
Sustainability, technology, and ESG will be key drivers of developments in natural resources over the next five years, with the asset class as a whole facing a huge upheaval.

There's a prudential aspect to energy that means the government needs to be involved. But the technologies coming through offer the opportunity to run much smaller-scale modular energy systems, which is an area that is ripe for private investors

Justine Bornstein
UK Research Lead for Energy & Transport
Deloitte

[2] https://www.iea.org/reports/covid-19-impact-on-electricity#changes-in-electricity-mix
[3] https://www.riotinto.com/news/releases/2020/Rio-Tinto-Executive-Committee-changes
[4] https://www.reuters.com/article/us-israel-desalination-ide-idUSKBN232175

Fig. 1.15: Fund Manager Views on How External Factors Will Impact Their Business over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

2. Investors

81% of investors in our *Future of Alternatives 2025* survey expect to increase commitments to alternatives in the next five years – just **3%** plan to decrease commitments

61% of investors intend to increase co-investment

More fund managers (**35%**) expect retail investors to account for more of their funds by 2025 than to account for less (**26%**)

Investors' Inexorable Push to Alternatives

The investor universe is evolving, as pressure to find higher returns to meet liabilities drives increasing allocations and newcomers to alternatives

Near-zero interest rates are expected to prevail in many parts of the world from now until 2023, if not beyond. Oxford Economics forecasts have central bank policy rates below 0.5% in the US, Germany, France, UK, and Japan until 2023, and not rising above 1% in any of those countries until 2026 (Fig. 2.1). This will stoke asset price inflation while compressing fixed-income yields, forcing more investors to seek alternative investments to stocks and bonds.

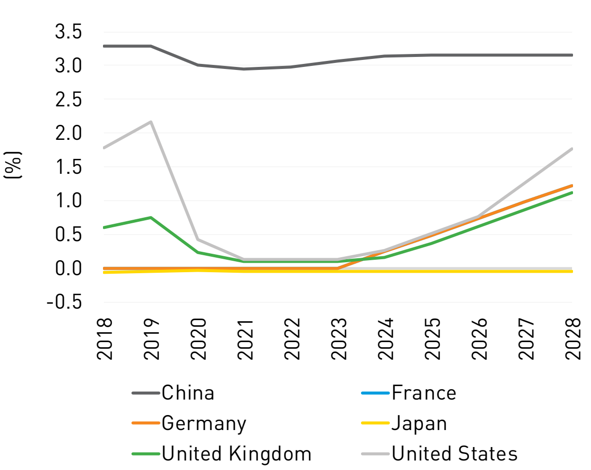
High valuations on blue-chip stocks will strengthen the case for investors to target private equity as a route to access the most promising start-ups and growth companies. Globally, 81% of investors polled by Preqin for *Future of Alternatives 2025* said they expect their allocation to alternatives to increase by 2025 (Fig. 2.2). Just 3% expect allocations to decrease.

The composition of alternatives portfolios will also evolve, with 79% of investors saying that they expect to deploy a larger proportion of their funds into private equity by 2025 (Fig. 2.3). Fifty-eight percent of managers expect their allocations to private debt to increase by 2025, while 56% plan to allocate more to infrastructure investments.

Relative to these asset classes, hedge funds and natural resources will be less popular with investors over the next five years, with less than a quarter expecting to increase allocations. This is not particularly surprising: private equity has historically outperformed public market equivalents and has a track record as the best-returning asset class for pension funds[1] over the long term. Preqin reports a 10-year horizon IRR for all private equity funds of 13.6%,

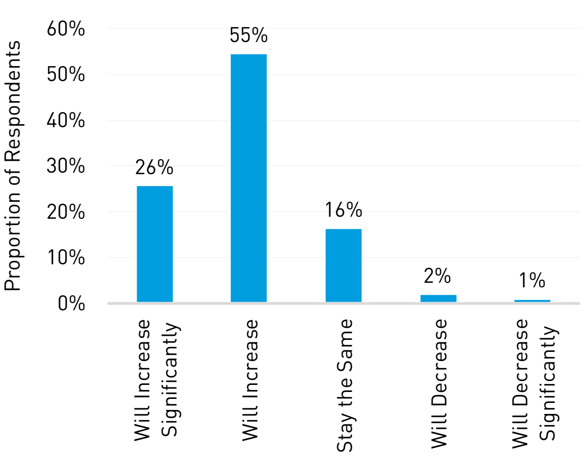
[1] *https://www.investmentcouncil.org/wp-content/uploads/pension-funds-and-private-equity.pdf*

Fig. 2.1: Central Bank Policy Interest Rates



Source: Oxford Economics

Fig. 2.2: Investors' Plans for Their Allocation to Alternatives by 2025



Source: Preqin Investor Survey, August 2020

with buyout the best performing strategy with a 14.4% horizon IRR over the period.

Investors' Need for Higher Returns

Over the next five years, population aging in developed countries will exacerbate an increase in liabilities and funding gaps at pension funds. This is a massive fundraising opportunity for managers of alternative assets with a proven ability to generate steady returns in a maturing market. Indeed, public pension funds tracked by Preqin have been steadily increasing allocations to alternatives over the past decade, with the median allocation rising from 18.1% in 2010 to 30.3% in 2020 (Fig. 2.4).

However, as the pensions industry continues to shift from defined benefit (DB) plans to defined contribution (DC) plans, a key issue for managers to address is how to manage liquidity and provide daily valuations for DC pension fund investors without compromising on returns. Some gatekeepers have launched open-ended or 'evergreen' investment vehicles that allow DC plans to invest in private equity, such as Partners Group Generations Fund[2]. More innovation in new investment structures can be expected over the next five years.

Investors Seek Multiple Routes to Private Equity

That said, the fund will remain the dominant vehicle. Almost half (49%) of investors in our survey expect to make greater use of pooled vehicles to invest in alternative assets over the next five years. This is especially so for investments in private equity, private debt, hedge funds, and infrastructure, whereas more investors still prefer to access real estate opportunities through co-investments or direct investments.

[2] *https://www.pggenerationsfund.com/en/home/*

In the private equity space, 61% of investors expect to do more co-investment deals by 2025, while 58% expect to make greater use of pooled vehicles (Fig. 2.5). The market for co-investments and secondaries will grow, driven in part by rising allocations from pensions with a lower tolerance for pensioners' savings being tied up as undeployed cash in a pooled fund.

Capital Will Concentrate and Bifurcate

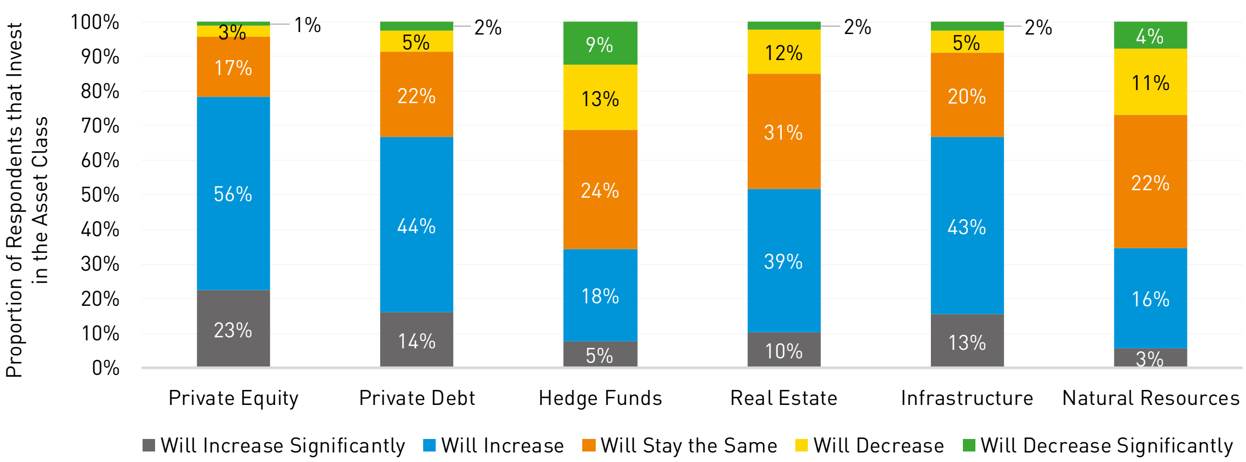
The trend toward greater concentration of capital among fewer funds will continue into 2025. We expect a smaller number of large and well-known GPs to continue to dominate fundraising. Preqin data shows the number of private equity funds closed worldwide declining in recent years, from a high of 2,674 in 2017 to 1,776 in 2019, with just 846 funds closed by mid-October 2020. In tandem, average fund size has risen from $247mn in 2017 to $390mn in 2019 and $450mn in 2020 to October.

This trend does not mean smaller and newer funds will be completely squeezed from the market, however. A full 79% of investors in our survey expect to increase the number of fund manager relationships over the next five years. Among smaller GPs, LPs will continue to seek out those with more focused strategies that can offer a differentiated risk/return profile.

Transparency Will Continue to Improve

As the alternative assets industry grows, rising allocations to private markets will no doubt renew calls for more transparency in how illiquid holdings should be valued and how rates of return should be reported.

Fig. 2.3: Investors' Plans for Their Allocation to Alternatives by 2025 by Asset Class



Source: Preqin Investor Survey, August 2020

One particular issue is standardization. Nearly three-quarters (73%) of investors in our survey said that inconsistent reporting from their managers is a challenge they face when investing in alternative assets, with two-thirds saying that getting an insufficient level of detail from managers is also a challenge (Fig. 2.6).

In the US, the Adopting Data Standards Initiative seeks to standardize how private equity firms report performance and fees, while larger LPs are pushing their GPs to report through a standard platform, giving an individual LP consistency across their own investments. We expect auditors, brokers, and regulators to come under more pressure from stakeholders to challenge the opacity of the alternatives industry over the next five years. And we believe that transparency between alternative assets stakeholders is good, and has improved further as a direct result of the COVID-19 pandemic.

Encouragingly, 85% of fund managers polled by Preqin anticipate that they will disclose more information to investors over the next five years. Fund managers that make the commitment to deepen their relationships with investors through better guidance and sharing of information stand to benefit from having more high-conviction clients that will stay with them through multiple generations of funds.

But Greater Scrutiny Is Inevitable

Against a backdrop of rising wealth inequality, and with fewer companies deciding to go public or stay public, public scrutiny of private equity-owned firms

Performance is what has driven so many major institutions to commit more funds – for example, in 2000 CalPERS had 4% of its funds in alternative assets; today that figure is 17%. We expect this trend to continue for the near future until investors have saturated their ability to onboard illiquid assets

Dominique Carrel-Billiard

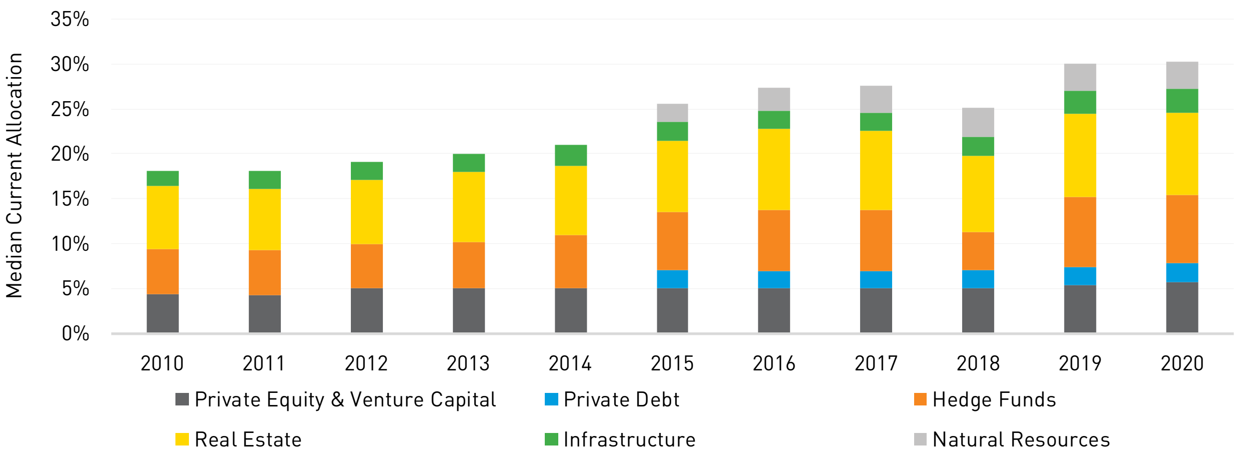
Deputy CEO of Amundi AM, and Head of Real and Alternative Assets
Amundi

will also intensify. Dividend recapitalizations have already come under fire as a tool used by managers to soup up private equity returns at the expense of a company's financial health, thereby introducing more instability into the economy. Carried interest, which in most regimes is taxed at a capital gains rate rather than income rate, has also been identified by critics as a tax loophole. More lobbying on these fronts can be expected over the coming years.

Broadly, management fees for active equity managers are roughly 20% lower in 2018 than they were in 2008, in part because passive funds have become so cheap, according to the Harvard Business Review.[3] Alternative

[3] https://hbr.org/2019/12/what-machine-learning-will-mean-for-asset-managers

Fig. 2.4: Median Current Allocations of Public Pension Funds to Alternatives by Asset Class, 2010 - 2020



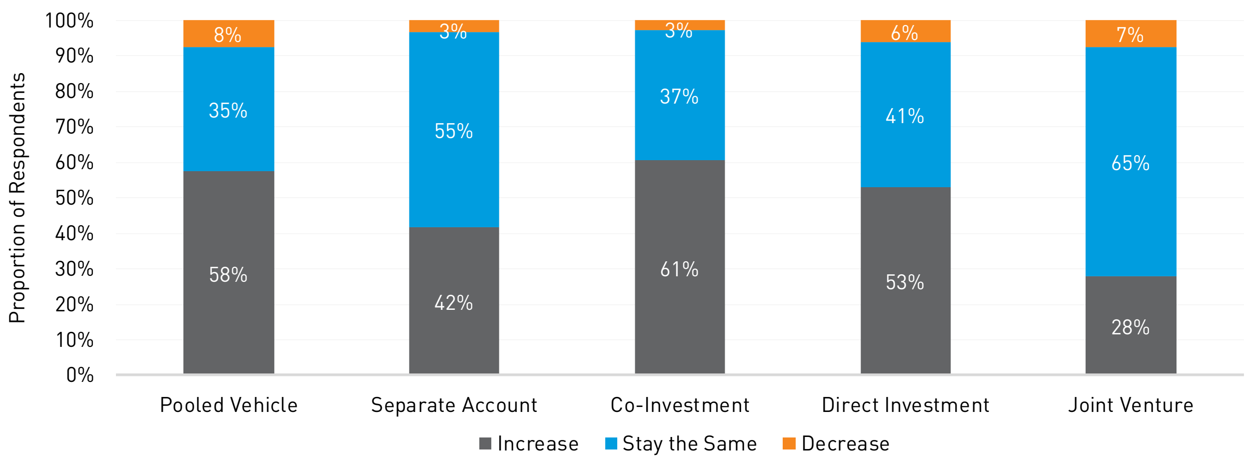
Source: Preqin Pro

asset managers will find it hard to escape this trend as the industry matures. The 2/20 fee structure traditionally associated with hedge funds and private equity funds is no longer the industry standard. A 2019 poll of hedge fund managers by the Alternative Investment Management Association (AIMA)[4] found that the average management fee for the sector had fallen to 1.3% of AUM, with managers becoming increasingly responsive to investors' desire for more equitable compensation arrangements.

Looking ahead, funds that are responsive to changing investor demands are best positioned to find new growth areas. For example, more 'bespoke' client solutions such as customized investment mandates and value advisory services have been introduced into the market over the years. While the best performing fund managers may be in a strong position when it comes to negotiating fees, it will be vital for the long-term health of the industry that reward and incentivization structures properly align the interests of all stakeholders.

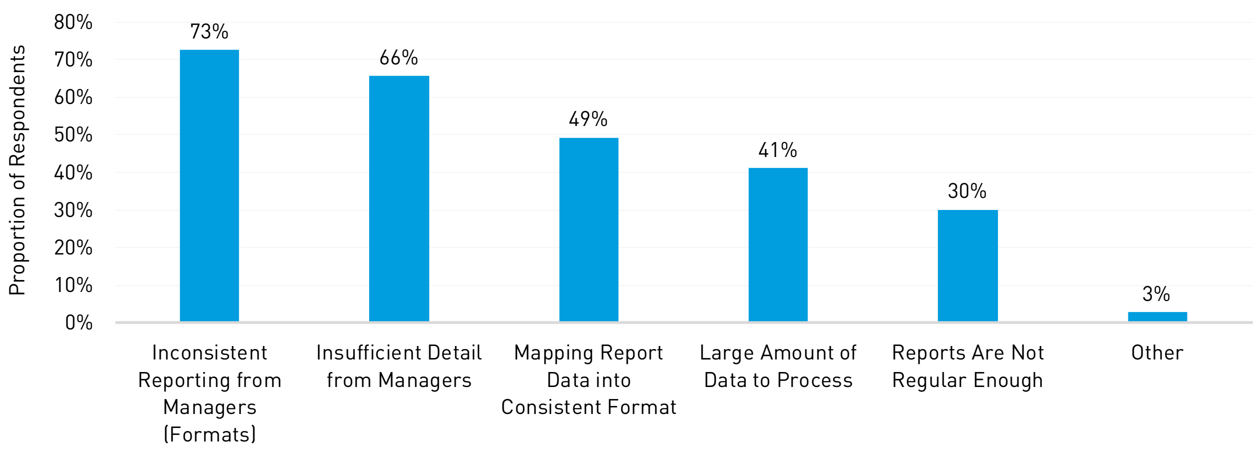
[4] *https://www.aima.org/article/press-release-aima-and-rsm-publish-in-harmony-paper.html*

Fig. 2.5: Investors' Plans for Their Allocation to Private Equity by 2025 by Structure



Source: Preqin Investor Survey, August 2020

Fig. 2.6: Investor Views on the Challenges of Investing in Alternatives from a Technology Perspective



Source: Preqin Investor Survey, August 2020

The Customer Must Come First

With the alternative assets industry at a crossroads, it must be responsible, diligent, and professional with all stakeholders to continue to grow, says Bill Kelly of the CAIA Association

It's 40 years since American academic Michael Porter codified the four phases of an industry lifecycle: introduction, growth, maturity, and decline. By virtually any measure, the alternative investment industry is well into its growth phase but, with less than 20% of the global assets under management (AUM) pie, there is still a lot of runway before maturity sets in. However, this is the time when the industry needs to be thinking and acting more like a profession with a purposeful mission centered around better outcomes for all investors.

Recent industry reporting has raised the specter of two related and important trends. First, while alternatives are still a relatively small part of global AUM, they represent close to 50% of the revenue earned on the manager side of the aisle. As alpha continues to morph into beta and indexation captures more market share in the traditional space, the secular trend toward alternatives has taken hold. Second, while the dominant asset owner is still institutional by definition, the rise of the retail investor continues to accelerate as a consequence of the sun-setting of the defined benefit retirement contract. What do these trends proffer through Mr Porter's phasing prism?

From a standing start today, the growth phase appears limitless. Central bankers have aided and abetted that growth with a risk-free rate offering little to no return on a nominal basis. Asset owners of all stripes have contractual obligations, constituency funding expectations, or retirement plans and dreams on the liability side of their balance sheets. Those expectations very often represent a sizable funding gap relative to the current investable assets in hand, and said gap will likely not be closed with a traditional 60/40 stock/bond approach.

Bill Kelly
Chief Executive Officer

CAIA
www.caia.org

William (Bill) J. Kelly is the CEO of the **CAIA Association**. Bill has been a frequent industry speaker, writer, and commentator on alternative investment topics around the world since taking the leadership role at the CAIA Association in January 2014. Previously, Bill was the CEO of Boston Partners and one of seven founding partners of the predecessor firm, Boston Partners Asset Management. Bill's career in the institutional asset management space spans over 30 years where he gained extensive managerial experience through successive CFO, COO, and CEO roles.

Expectations Must Be Managed

Many will take the view that alternatives will provide that secret sauce, expecting nothing short of divine intervention when what they truly need are realistic and disciplined solutions. Performance dispersion is getting wider across quartiles as median returns continue to show higher correlations to public market proxies. EBITDA multiples are at historic late-cycle highs at a time when dry powder is measured in trillions of dollars. Asset classes have morphed into complex industries and the premium on professional due diligence and proper training has never been so high.

Our industry is approaching the intersection of capitalism and stewardship, and only one path truly puts the client's interests first. Operating leverage for the manager has come down, but is still quite attractive relative to most industries, and there is nothing wrong with profit-driven motivations. However, let us recognize that our primary responsibility is to the end investor, who is getting less sophisticated as product access becomes more democratized. We must lead with transparency and increased financial education – wrapped in more outcome-based solutions – as we properly perpetuate a prosperous growth phase that is centered around the client.

The 'Retailization' of Private Markets

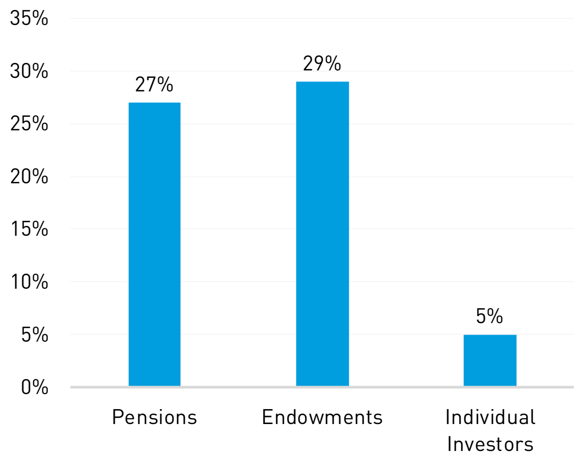
The trend of retail investors seeking alternative sources of returns that can offer diversification from traditional markets will be a significant force for change over the next five years

Private market opportunities that have only been accessible to accredited investors at a high minimum investment are increasingly opening up to retail market participation. In August 2020, the US Securities & Exchange Commission expanded its definition of 'accredited investor'[1] to allow more investors to participate in private offerings. The SEC expects the total pool of individual investable assets to rise from $70tn in 2018 to $106tn in 2025, while average allocations for individual investors are less than 5%, compared to 27% for pension funds and 29% for endowments (Fig. 2.7).

Back in June, the US Department of Labor, which governs 401(k) retirement accounts, clarified that under federal law DC pension plan fiduciaries can incorporate certain private equity strategies into diversified investment options, such as target-date funds. Analysts at Evercore estimate that as much as $400bn[2] in new assets, out of the $6.5tn 401(k) market, could make its way into private equity funds.

Among alternatives fund managers polled by Preqin, 35% expect retail investors to account for a larger proportion of their AUM over the next five years, compared with 26% that expect the retail proportion of their AUM to decrease (Fig. 2.8). That flow of retail funds into alternatives over the next five years will likely be slow and steady. To capitalize on any increase in 'retailization' in private markets, fund managers will need to add more customer-centric capabilities, such as more frequent and regular reporting, and develop a retail distribution channel.

Fig. 2.7: Average Allocation* to Alternatives by Investor Type



Sources: 2016 Willis Towers Watson Global Pension Assets Study; 2016 National Association of College and University Business Officers; Money Management Institute, "Distribution of Alternative Investments through Wirehouses."

Liquid Alternatives Grow Rapidly in Europe

Retail participation in hedge funds is more established. Liquid alternative funds – or liquid alts – have become the fastest-growing asset class[3] in the UK- and Europe-domiciled cross-border fund market since the 2008 financial crisis, according to Morningstar's Cross-Border Liquid Alternative Fund Landscape 2019 study. This is despite what Morningstar admits has been "outright disappointing" results, with liquid alts having generally underperformed hedge funds.

Hedge funds may find it increasingly important to have a retail investor strategy over the next five years. The growth of the liquid alts market is putting pressure

[1] *https://www.sec.gov/rules/final/2020/33-10824.pdf*
[2] *https://www.ft.com/content/263634aa-caa7-4c78-86f0-875f7e6bed86*
[3] *https://www.funds-europe.com/april-2019/liquid-alternatives-digging-deep-for-returns*
**Allocations shown are for US Pensions and US University Endowments.*

on traditional hedge fund fee structures, as mutual fund companies squeezed by low-cost ETFs launch more liquid alternative products. In Preqin's survey, a third of hedge fund respondents currently have a retail offering, with 15% saying they will maintain their current level of products and 18% intending to offer more by 2025 (Fig. 2.9).

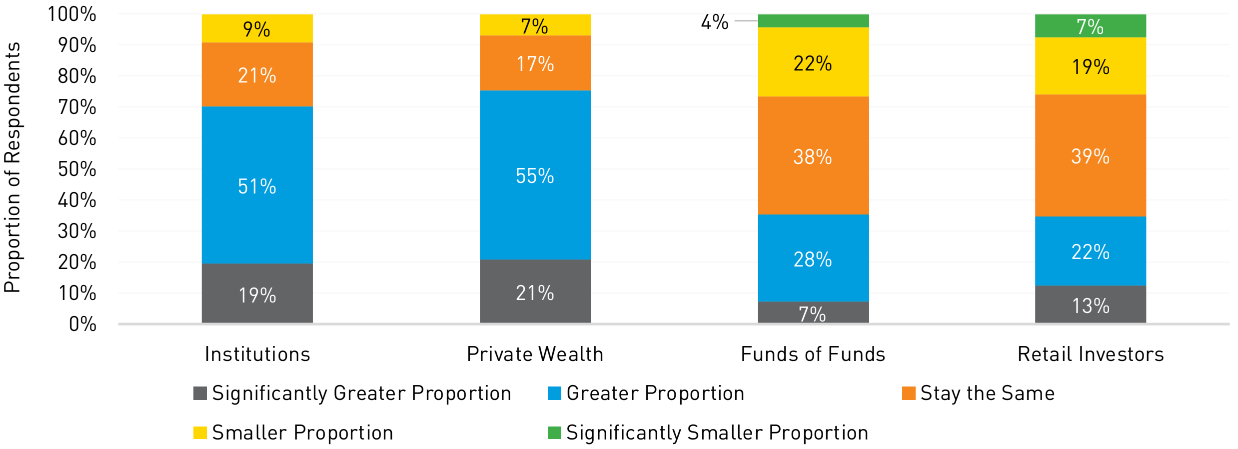
Responsible Investing for Retail Investors

We expect the retail investor contribution to alternatives AUM to continue to be dwarfed by that of institutions. However, it could have a disproportionately large impact on the profile and reputation of the industry, which could be a positive development. In the wider world, the terms 'private equity' and 'hedge funds' are rarely attached to positive stories. That said, most people who have delved deeper into the workings of these industries have discovered their importance to wider economies and the merits of the model.

Our industry is approaching the intersection of capitalism and stewardship, and only one path truly puts the client's interests first. The industry needs to be thinking and acting more like a profession with a purposeful mission centered around better outcomes for all investors

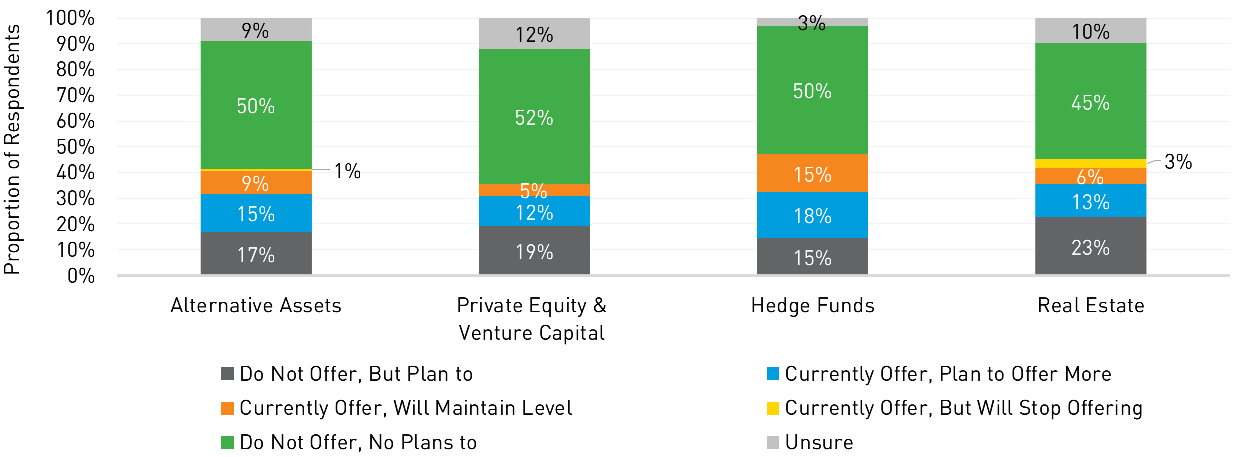
Bill Kelly
CEO
CAIA Association

Fig. 2.8: Fund Manager Views on How Their Proportion of AUM by Investor Group Will Change over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

Fig. 2.9: Fund Manager Views on How Their Offering to Retail Investors Will Change over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

3. Regions

Preqin forecasts **25.2%** CAGR for alternatives AUM in Asia-Pacific between 2020 and 2025. PEVC will account for **91.4%** of private markets AUM

48% of surveyed fund managers expect to source a greater proportion of capital from Southeast Asia

North America will maintain position as the largest alternatives market, with AUM rising to **$8.60tn** – the CAGR of **5.4%** is lower than the **9.8%** global average

Market Maturity in North America

Alternatives investors should keep their high-level allocation steady, but the make-up will favor dividend-like, lower-risk options

The North American alternatives market is mature compared to its global peers. It is the world's largest, with more than 60% of private assets invested in the region, and therefore likely to grow more slowly than emerging regions through to 2025. As Fig. 3.1 shows, Preqin predicts that North American alternatives AUM will grow an average of 5.4% a year through to 2025.

North American investors have not lost their appetite for alternatives, but some classes of investor may have reached a point where continued upward movement is unsustainable or impractical. For example, the region's largest public pension funds have not increased their alternatives allocations by more than one percentage point since 2012 (Fig. 3.2).

Complicating the issue for investors is the Fed's 'lower-for-longer' approach to interest rates, renewed amid 2020's COVID-19-related downturn. The ripple effect this creates through the economy lowers return expectations and discount rates, consequently increasing liabilities. This can be a boon for alternatives managers as it increases demand for exposure to higher-return assets.

Performance Will Drive Asset Classes

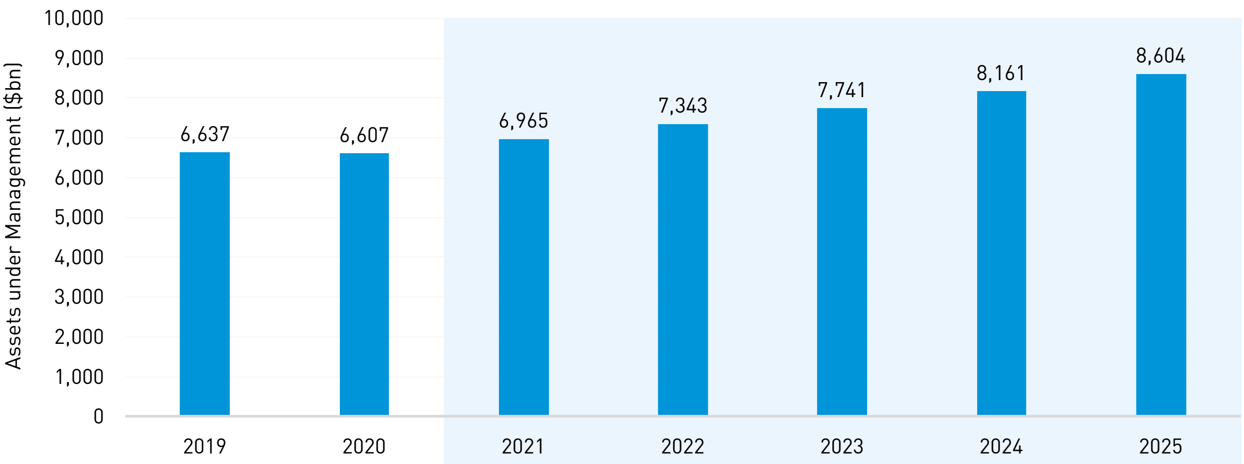
Private equity dominates the market, accounting for more than 60% of all private capital raised in the past decade. This is unlikely to change over the next five years. Over the 10-year horizon ending March 2020, North America-based private equity funds averaged a 14.3% annual return; however, the build-up of dry powder over the past decade points to difficulties deploying capital (Fig. 3.3).

Looking ahead, in its August 2020 capital market assumptions, investment giant BlackRock sees US private equity outperforming[1] every other asset class over both the middle and long term, with a mean expected return of 11.9%. That said, it does see a wider range of uncertainty than almost all other investments, from 2.4% for the mean uncertainty lower return to 22.3% for the mean uncertainty upper return.

Two asset classes that will attract more attention are private debt and infrastructure. Both offer yields higher than traditional fixed-income assets, which have been low and will remain low for some time. Preqin is forecasting global private debt AUM growth

[1] *https://www.blackrock.com/institutions/en-us/insights/charts/capital-market-assumptions*

Fig. 3.1: North America-Based Alternative Assets under Management and Forecast, 2019 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.* *Source: Preqin*

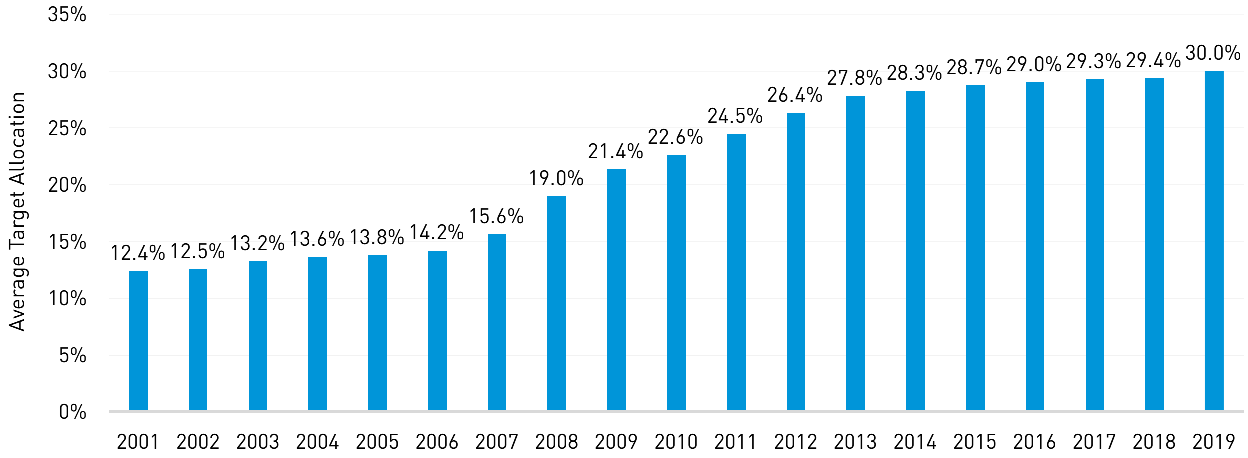
of 11.4% annually to 2025, which would make it the second fastest-growing asset class after private equity. Infrastructure, with its relatively safer risk/return profile, is predicted to grow 4.5% over the period.

We expect investor enthusiasm for North America to wane in favor of other markets. Currently, 57% of those surveyed for *Future of Alternatives 2025* believe North America is providing the best investment options at present, but that proportion drops to 38% for their 2025 predictions (Fig. 3.4). But, alternatives in North America are not going anywhere. The return premiums on offer compared with their public counterparts are too high to ignore.

2020 has forced us to reevaluate how we think about living and working – everything from the climate to politics and mental health, and especially racism. It's been scary, but necessary and overdue. Now we need to change our behaviors

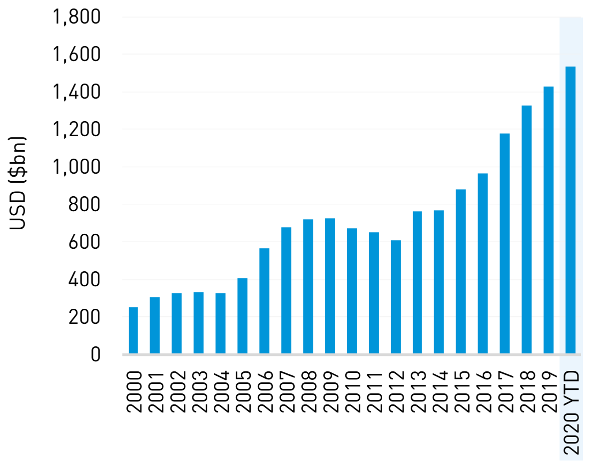
Kelsey Banos
Managing Director
First Republic Bank

Fig. 3.2: Average Target Allocation to Alternatives for US-Based Public Pension Funds, 2001 - 2019



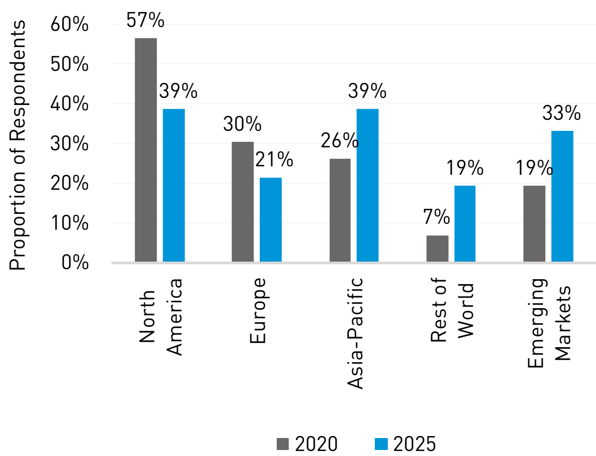
Source: Preqin Pro. Data as of August 2020

Fig. 3.3: North America-focused Private Capital Dry Powder



Preqin Pro. Data as of August 2020

Fig. 3.4: Regions Presenting the Best Opportunities for Investors, 2020 vs. 2025



Source: Preqin Investor Survey, August 2020

The Great Awakening in Asia

The new era of deglobalization is accelerating a shift in the center of gravity away from the West and toward Asia

Asia will solidify its lead in driving global growth in alternatives over the next five years. Asia-Pacific already accounts for more than half of the world's middle class, and the OECD expects[1] that share to keep rising. Mass urbanization across the region will increase infrastructure funding needs in sectors like healthcare, transport, logistics, and utilities.

Pension assets are forecast to grow at a pace of 3.5% a year to reach $6.8tn by 2025, according to PwC[2], while the expanding class of high-net-worth individuals (HNWIs) with investable assets in excess of $1mn presents another growing pool of capital for asset managers to service. There are currently 6.5 million HNWIs in Asia-Pacific with combined financial wealth of $22.2tn, and Capgemini expects[3] this number to surpass $42tn by 2025.

Fund managers are most bullish about their prospects of raising capital from Southeast Asia, with China in second place. Nearly half (48%) of surveyed managers expect Southeast Asia to account for a greater proportion of their AUM over the next five years (Fig. 3.5).

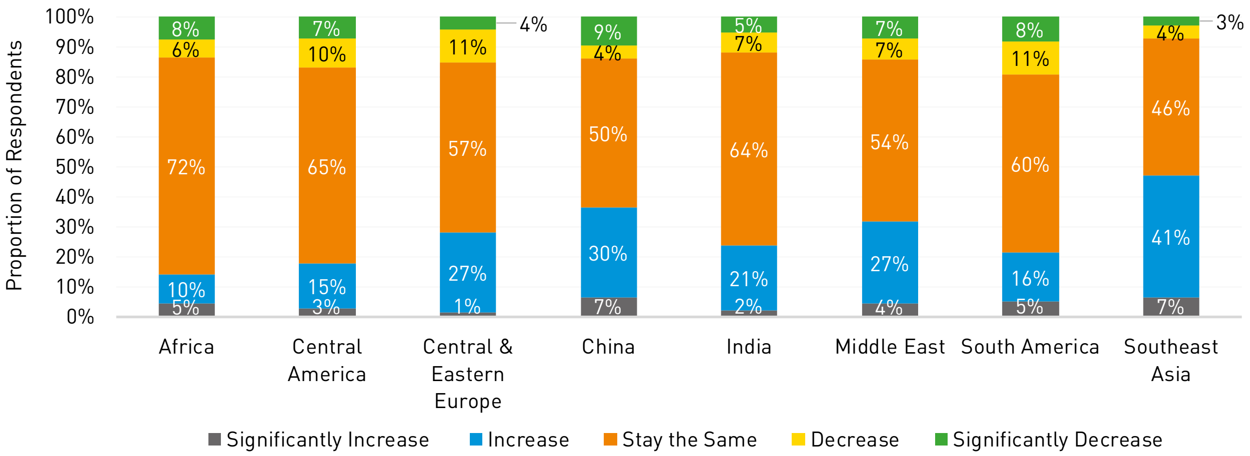
New Sources of Capital

Preqin forecasts that Asia-Pacific's private market AUM will grow from $1.62tn in 2019 to $4.97tn in 2025, at a world-beating CAGR of 25.2% (Fig. 3.6). This is faster than any other region and more than twice the forecasted growth rate of 9.8% for global private markets.

Asia-Pacific will be a prime hunting ground for private equity funds going toward 2025. The new era of 'slowbalization' has accelerated a shift in the center of gravity away from the West and toward Asia. The flaring of US-China tensions in 2018 forced more companies to diversify their sourcing origins and reroute supply chains, strengthening intra-Asia trade and the region's position as a global manufacturing powerhouse.

[1] *https://www.eastspring.com/insights/the-asian-century-what-s-next*
[2] *https://www.pwc.com/sg/en/asset-management/assets/asset-management-2025-asia-pacific.pdf*
[3] *https://worldwealthreport.com/resources/world-wealth-report-2020/*

Fig. 3.5: Fund Manager Views on How the Proportion of Their AUM by Investor Location Will Change over the Next Five Years



Preqin Fund Manager Survey, August 2020

Technologies for the Future

In parts of Asia, population aging is a concern, but investments in robotics and other productivity tools have also put the region at the forefront of the automation revolution. South Korea, Singapore, Thailand, and China are far ahead of Europe and the US in terms of robot adoption, after controlling for different wage levels[4] (and hence different costs savings) in each of these markets.

Governments in Asia-Pacific are also focusing on productivity reforms to sustain growth. South Korea's Digital New Deal program will invest in building out its data, network, and artificial intelligence industries in the years to come. Policy-makers in Japan, Singapore, Malaysia, Indonesia, and the Philippines are also pushing for digital transformation. China is far ahead of other countries in 5G mobile communications architecture development, while Asia-Pacific is the leading region in 5G adoption. Mobile operators in Asia-Pacific will invest over $400bn[5] in their networks between 2020 and 2025.

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[4] *http://www2.itif.org/2018-industrial-robot-adoption.pdf*
[5] *https://www.gsma.com/mobileeconomy/wp-content/uploads/2020/06/GSMA_MobileEconomy_2020_AsiaPacific.pdf*

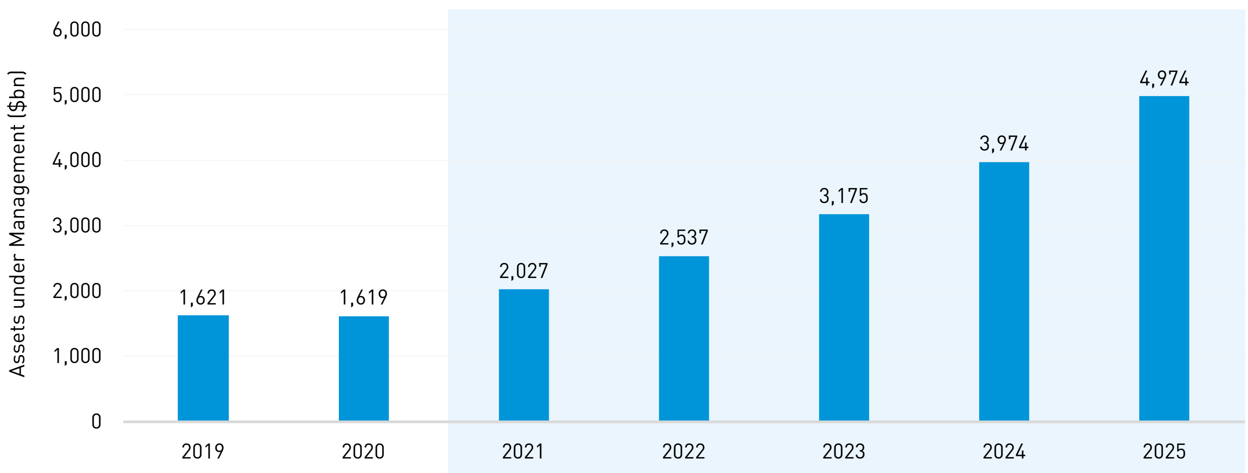
Today's GPs will need to articulate a disciplined and consistent capital-market-oriented strategy for every investment to both LPs and company founders. There must be a clear roadmap to future success to remain competitive in China's rapidly expanding PEVC market

Ming Liao
Founding & Managing Partner
Prospect Avenue Capital

Returns in Asia still look very strong, so interest in regional venture capital opportunities will continue to grow. Even among our own investor base, LPs that have previously felt they would never look at venture capital – let alone in Asia – are starting to change their mind

Kenneth Leong
COO & CFO
Axiom Asia Private Capital

Fig. 3.6: Asia-Pacific-Based Alternative Assets under Management and Forecast, 2019 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.* *Source: Preqin*

Success in China Will Require a Robust and Consistent Strategy

China's consumer retail industry is booming, but investment success will depend on a rational, capital-market-driven investment strategy, says Ming Liao of Prospect Avenue Capital

China's private equity & venture capital (PEVC) industry is getting increasingly competitive, with capital surging into the country's vast consumer market. In this environment, simply investing in this fast-growing market will no longer guarantee the future success of fund managers. Going forward, GPs investing in Chinese consumer companies will need a robust valuation and disciplined capital-market-oriented investment strategy to profitably monetize their portfolios by 2025.

These two factors should be especially top of mind for PEVC investors right now. The consumer retail sector in China has been an unusual hotbed for private market investment activity this year. In the face of further deteriorating geopolitical relations with the West, domestic household spending is seen as a primary driver of China's future growth. Investors have responded quickly, snapping up stakes in consumer companies expected to benefit from more inwardly oriented economic policies.

Investor appetite has pushed valuations skyward. In the public market, China's largest bottled water maker, Nongfu Spring, experienced a very warm welcome for its Hong Kong IPO. Its book was covered dozens of times and 'mega-long funds' were clamoring for a piece of the offering. Most impressive was the company's IPO valuation of 35x price-to-earnings (P/E) of 2021 projected net income – it traded at more than 50x P/E ratio for its 2020 earnings post-IPO. Consumer retail companies are typically valued at 20-25x, a measure of the optimism surrounding these companies.

Ming Liao
Founding & Managing Partner

Prospect Avenue Capital

We are a $500mn growth capital fund focusing on China's technology and internet sectors. Established in February 2018, **PAC** has deployed more than $200mn, including seven mid- to late-stage investments. Except one US IPO in 2019, PAC expects three more US IPO listings in 2021. PAC's founding partner Ming Liao is a Princeton graduate and Morgan Stanley-trained former investment banker. He earned his BA in Economics in China and his Master in Public Affairs in Economics at the Woodrow Wilson School of Public and International Affairs at Princeton University. Apart from Morgan Stanley, he held senior executive roles at Carlyle Group and UBS AG.

Valuation Methodology Matters

Public appetite for the sector has been spectacular, but it is encouraging a worrying new trend in private market valuation methods. Unlike Silicon Valley-based VCs, which rarely make investments in the consumer retail industry, China-based PEVC fund managers expect investments in consumer retail start-ups to achieve impressive levels of return – just like that of popular internet and technology companies. To achieve this, domestic GPs encourage heavy subsidizing of customer acquisition and revenue growth regardless of profitability on the road to a quick exit via IPO. However, this approach is unsustainable, as seen with recently delisted Xiamen-headquartered Luckin Coffee, which pursued this strategy before its accounting fraud was exposed by China's Ministry of Finance earlier this year.

Consumer retail business models are completely different from technology ones. Successful investment tactics applied in technology start-ups do not translate seamlessly to consumer retail, despite both industries valuing large customer bases and gross merchandise value (GMV). Indeed, brand perception and long-term profitability are the core drivers of success in consumer retail companies. These factors depend on years of providing quality products, services, and consistent marketing, all of which cannot be realized over a short period of time.

Lacking profitable cash flows, PEVC fund managers backing consumer retail start-ups have increasingly come to rely on price-to-sales (P/S) ratios. This practice is now seen across traditional food & beverage businesses, cosmetic products, and newly minted retail brands, leading to a growing number of investments at highly inflated valuations. As demonstrated by historical data, most of these deals have a very low chance of ever being exited successfully in the future. Indeed, some retailers with more than $1bn in revenues are still deep in losses – with profitability far out of reach.

With IPOs in the US and Hong Kong likely to remain the primary method for PEVC funds exiting Chinese companies for the foreseeable future, investors need to remember that public capital markets have always valued the consumer retail industry on a P/E basis. To set up for a profitable exit, investment strategies in the private market must consistently adopt the valuation methods applied by the public market. This disciplined approach is especially important for funds jumping into the consumer retail deal mania this year, as their portfolios plan for fast-approaching exit timelines over the next few years.

LPs Expect Disciplined Investment Strategies

While institutional investors and start-ups have traditionally valued, and will continue to expect, both capital and resource contributions from their GPs, they are increasingly demanding a more disciplined and consistent investment strategy. Moreover, LPs are becoming ever more vigilant of possible turns in liquidity conditions and the business cycle, motivating institutional investors to look beyond brand names to find fund managers that are methodical and sustainable.

There is no shortage of fund managers in China's PEVC industry, which boasts almost 10x as many firms as the US. Spoiled for choice, international LPs have become more selective, searching for local teams with tested strategies that can be repeatedly applied to many investment opportunities. This sustainable strategy has become even more crucial and necessary for LPs than analyzing each specific investment made by a particular fund. Faced with the current boom in consumer retail and subsequently inflated valuations in the sector, LPs investing in China should continually monitor GPs to ensure adherence to a disciplined investment approach.

Spoilt for choice with investment opportunities, today's GPs will need to articulate a disciplined and consistent capital-market-oriented strategy for every investment to both LPs and company founders. There must be a clear roadmap to future success to remain competitive in China's rapidly expanding PEVC market.

Growth in Europe amid Headwinds

Market uncertainty poses challenges, but European alternatives are set for continued growth over the next five years

A number of overarching themes will characterize the investment landscape in Europe over the next five years. The immediate uncertainty is COVID-19 and how the EU's €750bn recovery fund[1] will impact economies when it starts to be distributed in 2021. How Brexit unfolds will also have a significant impact on Europe's alternative asset management landscape in 2025.

Europe's aging population will progressively alter the region's economies over the coming decades. The number of people aged over 65[2] in Europe is projected to increase from 101 million in 2019 to 149 million in 2050. The extent to which this is a burden on government finances and a drag on growth, or whether Europe's 'silver economy' will create new services and stimulate progression, will be a significant determinant of the region's future prosperity.

These challenges, combined with the relative attractiveness of other markets, look to be weighing on the minds of fund managers. Among those surveyed for *Future of Alternatives 2025*, 30% see Europe as providing the best opportunities for investment now, but this proportion decreases to 21% with managers' predictions for 2025.

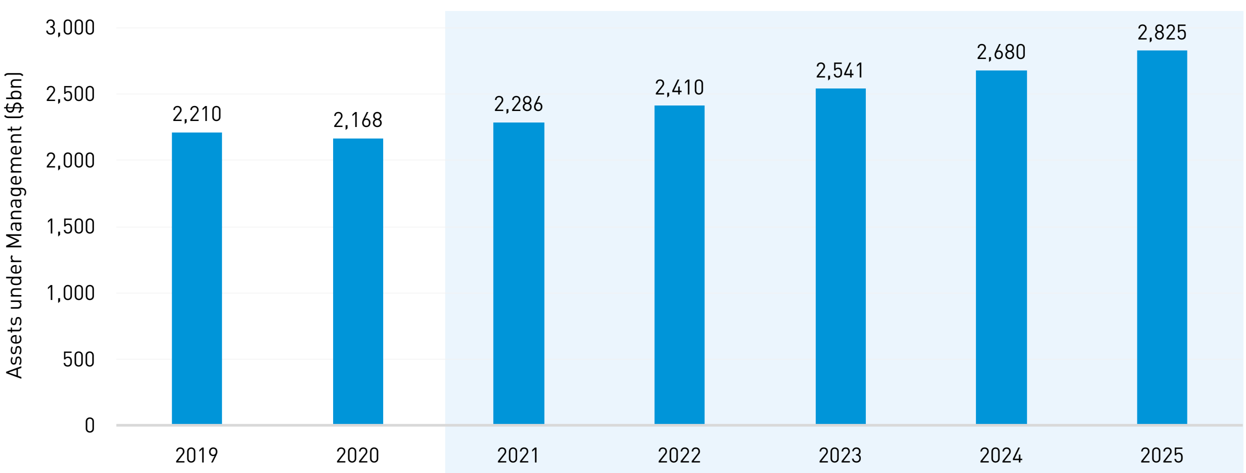
Despite the uncertainty, European alternatives AUM is set to grow. Preqin is forecasting a CAGR of 5.4% between December 2020 and December 2025, with total AUM increasing from $2.17tn to $2.83tn (Fig. 3.7). In 2020, the European alternative assets industry stands in between the large, developed market of North America, and the high-growth industry of Asia-Pacific. By 2025, this will have changed: Preqin predicts that alternatives AUM in Asia-Pacific will grow at a faster rate (25.2%) than that of Europe over the next five years.

Private equity will remain the largest of the alternative asset classes in Europe, with a predicted CAGR of 6.5% through to 2025 taking AUM to $4.36tn. Private debt is expected to grow at a CAGR of 17.3% and hit $576bn in 2025.

Real assets have seen significant deal activity over the past decade (Fig. 3.8). The number of private equity

[1] https://ec.europa.eu/info/strategy/recovery-plan-europe_en
[2] https://ec.europa.eu/eurostat/documents/3217494/10166544/KS-02-19%E2%80%91681-EN-N.pdf/c701972f-6b4e-b432-57d2-91898ca94893

Fig. 3.7: Europe-Based Assets under Management and Forecast, 2019 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

real estate deals increased from 322 in 2010 to 2,492 in 2019, while their value surged from $17bn to a high of $143bn in 2018. The following year saw a drop to $93bn, with the particular problems caused by COVID for real estate deals likely to result in further falls in 2020. Private infrastructure investment value had been above $85bn each year in the past decade, peaking at $205bn in 2018.

Moving on from Brexit

The biggest potential impact of Brexit on the alternatives industry is likely to be on fundraising. Details on fund passporting and how the Alternative Investment Fund Managers Directive (AIFMD) will apply to UK funds going forward are still to be worked out, though in practice these are unlikely to be significant barriers to investment. More than half (56%) of the fund managers surveyed by Preqin do not expect Brexit to impact their business over the next five years.

Across Europe, countries are focused on the urgent task of rescuing their stricken economies. Both France and Germany have unveiled $100bn+ stimulus packages. France's includes plans for $8.4bn of investment in the digital sector[3] over the next two years, including start-up investment, infrastructure investment, and digital transformation. This comes at a time when France is already seeing activity in digital infrastructure, as reported in Preqin's *Alternative Assets in Europe* report.

In Germany, the transformation of the country's SMEs – known collectively as the 'Mittelstand' – will continue to attract private capital investors keen to play a role in managing succession at the firms that are the backbone of the economy. German SME bank KfW calculated that in 2016, 39% of all business owner-managers were over 55, up from 20% in 2002, meaning that some 1.4 million SME owner-managers are approaching or past retirement age.[4] The Mittelstand has long been of interest to private equity firms, but with McKinsey reporting[5] that 77% of Mittelstand businesses surveyed in April 2020 were positive on the outlook of their business, private equity fund managers will have to continue to patiently develop relationships if they are to gain access to this treasure trove of industrial companies.

Our most recent fundraise has positioned us as one of the larger GPs in Europe, but for far longer we've been the largest software and tech-focused investor in Europe. We talk of ourselves as a software company with 30 divisions. This is our vision for the future of private equity

David Toms
Head of Research
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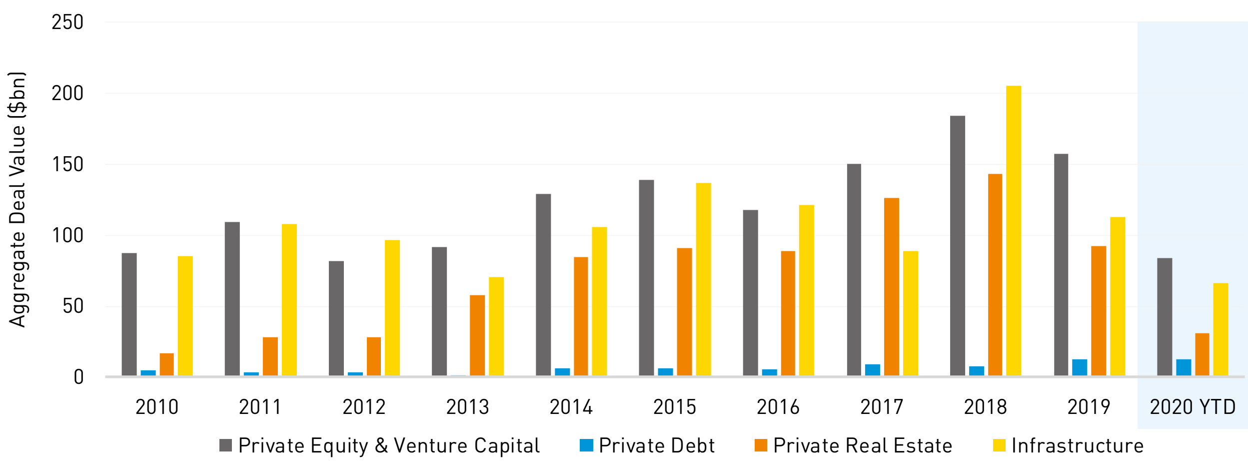
[3] *https://techcrunch.com/2020/09/03/france-to-spend-8-4-billion-on-digital-as-part-of-stimulus-plan/*
[4] *https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-KfW-Mittelstandsatlas/KfW-Mittelstandsatlas_2018_EN.pdf*
[5] *https://www.mckinsey.com/business-functions/mckinsey-digital/our-insights/how-the-german-mittelstand-is-mastering-the-covid-19-crisis*

Fig. 3.8: Aggregate Value of Private Capital Deals in Europe, 2010 - 2020 YTD



Source: Preqin Pro. Data as of September 2020

Middle East Heavyweights Will Look Closer to Home

Private capital investors in the Middle East are uniquely placed to prosper as the region's economies reduce their reliance on fossil fuels

Economies in the Middle East are at a crossroads. COVID-19 and the decline in oil prices are increasing the need for structural economic reform. In its October 2020 MENA Economic Monitor[1], the World Bank called for "profound institutional reforms" to reshape the role of the state, promote fair competition, accelerate the adoption of digital technology, and pursue regional integration.

Private investors in the region are uniquely placed to play a key role in the forthcoming economic transformation. The Middle East is home to some of the world's largest investors, with the 10 largest institutions in the region managing a combined $3.71tn, according to Preqin Pro. The domestic investor landscape is dominated by sovereign wealth funds, which comprise seven of the top 10 investors, and account for 57% of the AUM in alternatives (Fig. 3.9).

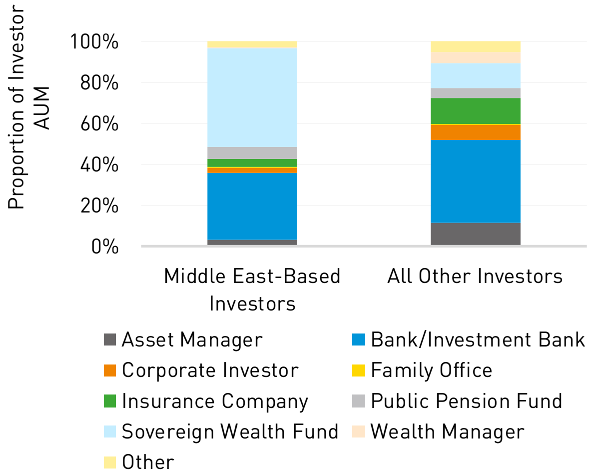
Sovereign wealth funds have a long track record in alternatives and will turn an increasing proportion of their capital to domestic markets. The largest, Abu Dhabi Investment Authority (ADIA) with total AUM of $579.6bn, currently has 23% of its assets allocated to alternatives[2], with a stated target range of between 13% and 33%.

Abu Dhabi-based Mubadala also pursues both global and domestic investments and has been increasingly active in the Middle East. In 2018 it bought Amana, a provider of inpatient rehabilitation, long-term care, and home healthcare in the UAE. The acquisition provided an exit for Gulf Capital, which had facilitated a bespoke and secured mezzanine facility through its private debt fund.

Fund Managers Are Finding Success

Preqin data shows that institutions from outside the region have $268bn invested in regional alternatives, with banks the largest grouping, accounting for 41% of the total. Since the collapse of private equity group Abraaj in 2018, regulators have made moves to reassure the international investment community. Private capital AUM at Middle East-based fund managers has declined slowly in the past decade,

Fig. 3.9: Private Capital Investor Assets under Management by Type: Middle East Based vs. All Other Investors



Source: Preqin Pro

> **In emerging markets, the lines in the capital structure can easily be blurred. Clearly defined investment criteria, sector focus, structuring, and the ability to assess unintended equity risk are critical to generating attractive returns**
>
> **Omar Rifai**
> Managing Director
> Gulf Capital

[1] *https://www.worldbank.org/en/region/mena/publication/mena-economic-monitor*
[2] *https://www.adia.ae/En/Investment/Portfolio.aspx*

recording a fall from $24bn as of December 2011 to $22bn in March 2020, according to Preqin data. The is due to a decrease in the amount of dry powder from $7.1bn to $5.3bn in the period, indicating that fund managers are finding attractive opportunities to deploy capital. As Fig. 3.10 shows, the 10 largest Middle East-based funds currently in market are seeking a combined $3.6bn.

Preqin is forecasting a CAGR in AUM outside the large regional markets of North America, Europe, and Asia of 11.1% (Fig. 3.11), a faster rate than the global estimate of 9.8%.

Key to economic success will be increasing intraregional trade[3], which the OECD said accounts for just 10% of the region's trade – the majority (55%) is with Asia. The Middle East's growing private capital industry can play a valuable role, and in many sectors investors are applying expertise learnt in other markets to create regional champions.

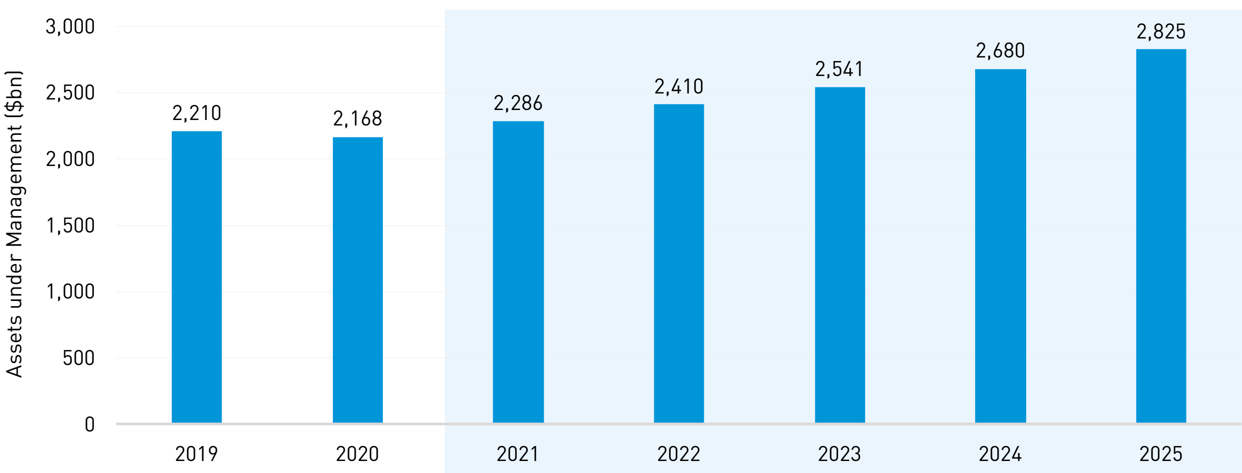
[3] *http://www.oecd.org/mena/competitiveness/WGTI2018-Trends-Trade-Investment-Policies-MENA-Nasser-Saidi.pdf*

Fig. 3.10: Largest Middle East-Based Private Capital Funds in Market

Rank	Fund	Firm	Firm Headquarters	Target Size (mn)	Fund Type	Geographic Focus
1	Rakiza Infrastructure Fund	Oman Infrastructure Investment Management	Oman	1,000 USD	Infrastructure Value Added	Oman, Turkey, MENA
2	Investcorp-SLA Gulf Fund	Investcorp	Bahrain	800 USD	Infrastructure Opportunistic	Middle East, GCC
3	Investcorp Strategic Capital Partners	Investcorp	Bahrain	750 USD	Buyout	US, Asia, Europe
=	Investcorp US Buyout Fund 2019	Investcorp	Bahrain	750 USD	Buyout	US
5	Investcorp Asia Food Growth Fund I	Investcorp	Bahrain	500 USD	Growth	China, Singapore, Asia, ASEAN
=	Mubadala Infrastructure Partners Fund II	Mubadala Infrastructure Partners	United Arab Emirates	500 USD	Infrastructure Opportunistic	North America, Africa, East and Southeast Asia, Middle East, Sub-Saharan Africa, South Asia
7	Mubadala European Fund	Mubadala Capital	United Arab Emirates	400 USD	Early Stage	UK, Europe
8	Cedar Aviation Finance	Novus Aviation Capital	United Arab Emirates	300 USD	Mezzanine	Global
=	Investcorp US Student Housing Fund	Investcorp	Bahrain	300 USD	Real Estate Core	US
10	Alpha Wave Incubation	ADQ	United Arab Emirates	1,100 AED	Early Stage: Start-up	India, Southeast Asia

Source: Preqin Pro. Data as of October 2020

Fig. 3.11: Europe-Based Assets under Management and Forecast, 2019 - 2025*



**2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.*

Source: Preqin

Latin America's Growing Appetite for International Private Equity Exposure

Political and macroeconomic challenges in the region are accelerating the flow of domestic capital offshore – and increasingly into the hands of private equity firms

In 2019, Latin America was rocked by a wave of civil unrest, including in the Chilean capital of Santiago. Part of public anger was directed toward the private pension fund system, established in the 1980s under the Pinochet Government as Chile underwent an economic transformation. Nationwide, all employees have been required to allocate at least 10% of earnings into one of several defined contribution schemes, known as AFPs. Similar systems were subsequently implemented across Mexico, Peru, and Colombia. Preqin data shows that total assets across all four of these markets are now approaching $500bn.

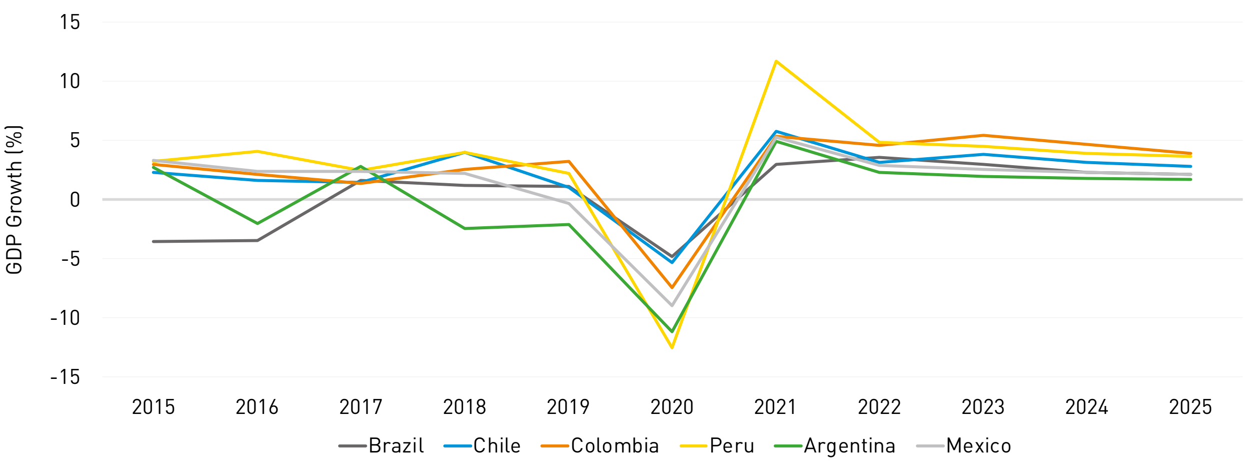
Regional Pension Funds Turn Outward for Alternatives Exposure

AFPs are leading the way on increasing exposure to international private equity. Large international investment allocations are nothing new in Latin America, given the lack of explicit liabilities to match and the relatively shallow domestic equity markets in which to invest. However, allocations to international private equity funds have started to accelerate in recent years as allocators pursue diversification and higher returns. With private equity allocations still in the low single digits, AFPs have considerable headroom to invest.

Ongoing macroeconomic challenges may depress expected returns from Latin American assets and accelerate the shift to investments further afield. Indeed, COVID-19 has hit the region disproportionately hard: Chile, Peru, and Brazil have all recorded more cases per million than the US[1] after 70 days from their respective outbreaks. While the region's largest

[1] https://www.newscientist.com/article/mg24632863-300-how-south-america-became-the-new-centre-of-the-coronavirus-pandemic/

Fig. 3.12: Real GDP Growth in Latin America, 2015 - 2025



Source: Oxford Economics

economies are expected to rebound next year from severe slowdowns in 2020, forecasts for GDP growth of between 2.2% in Mexico and 3.9% in Colombia for 2025 are modest by emerging market standards (Fig. 3.12).

In Brazil, Scarce Capital Stays Onshore

Notably, Brazil is proving the exception to the trend of increasing offshore investment. Although Brazil is the largest economy in Latin America, with sizable pension funds of its own, it also lacks domestic savings and the cost of borrowing is stubbornly high. Brazilian pension funds allocate a negligible amount to offshore private equity funds due to regulatory restrictions. We consider it unlikely that the regulators will relax their conservative stance any time soon, preventing further offshore capital flows.

The combination of high currency volatility and high borrowing costs reduces the feasibility and attractiveness of Brazilian buyout funds, especially for international investors. A marked improvement in economic growth conditions, or strong return projections at an asset level, would be needed to help alleviate these concerns. However, the venture capital space is a bright spot, which is likely to garner more attention in the coming years. Preqin Pro tracks 126 fund managers currently investing in Brazilian venture capital.

Global Investors See Opportunities in Latin America

The private equity market in Latin America has grown over the past decade. Data from Preqin Pro shows the annual number of private equity transactions in Latin America increased from 133 in 2010 to a high of 400 in 2019. The aggregate value of these deals has climbed more slowly, from $8.8bn to $10bn in 2019. Private equity fundraising, however, has been on a declining

AFPs are leading the way on increasing exposure to international private equity. Allocations to international funds have started to accelerate in recent years as allocators pursue diversification and higher returns

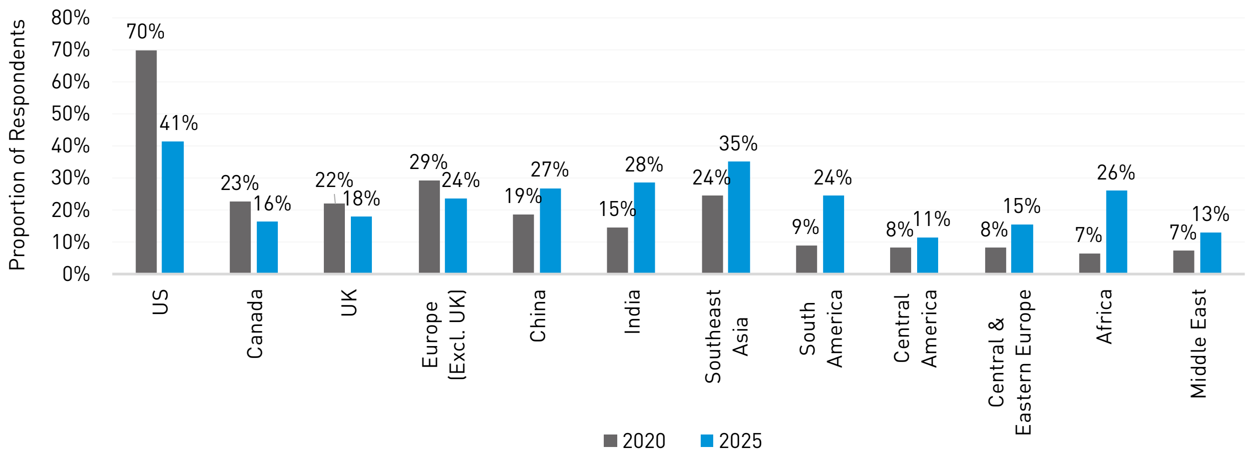
Cameron Joyce CFA
VP, Research Insights
Preqin

trend, sliding from a high of $11bn in 2011 to $2.8bn in 2019, which should benefit those still in the market with capital to deploy.

Although the majority of investors we surveyed for *Future of Alternatives 2025* do not invest in Latin America, 12% of respondents that do not currently invest in the region plan to start by 2025. What's more, while only 9% of fund managers believe South America is presenting the best investment opportunities at present, almost a quarter (24%) see some of the best opportunities in 2025 (Fig. 3.13).

While Latin America is not a market for the faint hearted, there will be opportunities for investors and fund managers that are prepared to dig deep.

Fig. 3.13: Fund Manager Views on Which Markets Present the Best Opportunities, 2020 vs. 2025



Source: Preqin Fund Manager Survey, August 2020

African Private Capital Can Flourish with the Right Reforms

With a growing population and increasing foreign investment, African private markets have great potential, provided essential economic and social policy reforms are implemented

Despite the relatively modest size of Africa's private capital market, it is expected to grow significantly by 2025. Africa's economic outlook has deteriorated with COVID-19, but with many African governments proposing ambitious economic and policy reforms, the market is set to become more attractive for investors. Nigeria, which recently overtook South Africa as the continent's largest economy, is forecast to grow at more than 4.5% in 2024 and 2025, the fastest rate among the five largest economies (Fig. 3.14).

Fund managers are taking a favorable view of the region. More than a quarter (26%) of those surveyed by Preqin for *Future of Alternatives 2025* say that Africa as a region will present the best opportunities for investment in five years' time.

Despite being home to 17% of the world's population, Africa accounts for just 4% of global power supply investment.[1] In order to achieve reliable electricity supply, a substantial increase in investment is required. Private capital professionals have the resources, skills, and technology know-how needed to make impactful investments in this field. Regulatory and policy reforms will need to be successfully implemented to attract private investors through structures that also ensure the more effective use of public capital.

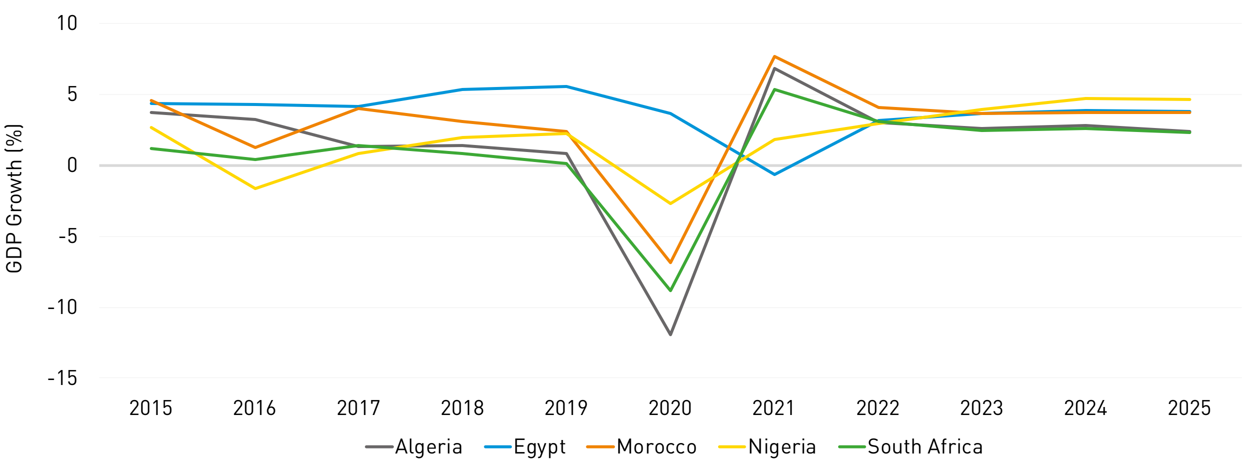
AfCFTA to Boost Intraregional Trade

Africa has long been dependent on foreign direct investment (FDI), which is expected to decline by 25-40% in 2020 due to falling commodity prices and the impact of COVID-19, according to UNCTAD.[2] The impact of this on the region's economies may not be as bad as the headline figure suggests, with UNCTAD pointing

[1] *https://www.iea.org/reports/africa-energy-outlook-2019*

[2] *https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=2400#:~:text=The%20trend%20of%20declining%20foreign,prices%20of%20commodities%2C%20especially%20oil.*

Fig. 3.14: Real GDP Growth Forecasts in Africa, 2015 - 2025



Source: Oxford Economics

to deepening regional integration due to trade finally starting under the African Continental Free Trade Area (AfCFTA).

The sources of FDI and trade are also changing (Fig. 3.15). Chinese investment in Africa has been rising steadily over the past 15 years, with a total of $304bn in investment and construction between 2005 and 2020, according to AEI's China Global Investment Tracker.[3] A third of Chinese investment is in transport, a third in energy, and 11% in metals, according to analysis by the Brookings Institute.[4]

The opening up of capital markets in Africa has created opportunities for foreign investors, with a number of African nations having established stock exchanges as well as bond and money markets. The growing ambitions of countries like Turkey and India could spur a new wave of FDI into public infrastructure and private sector developments, in turn fueling domestic opportunities and the balance of trade, according to Investec.[5]

Turning the Tide

Most institutional investors have historically chosen not to invest in alternatives in Africa, but this may be starting to change. While 72% of investors we surveyed do not currently invest in the continent, 11% have plans to increase their investments by 2025.

Preqin Pro tracks 540 Africa-based alternatives fund managers, with the largest number located in South Africa (252), followed by Nigeria (63), Egypt (41), Kenya (28), Ghana (18), and Morocco (13). A further 62 funds are based in Mauritius, which has pursued aggressive tax policies to attract international capital.

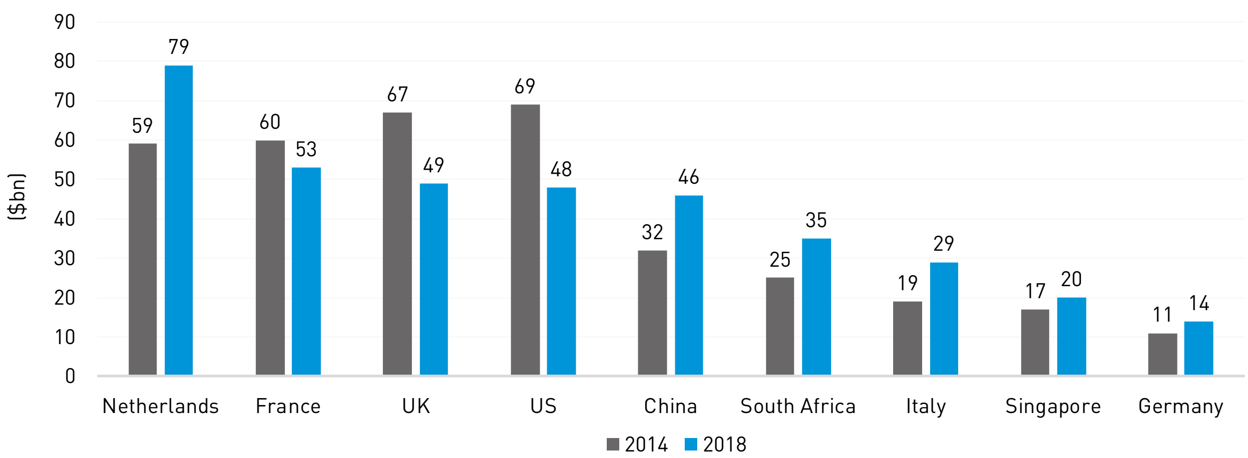
Further development in infrastructure underscores all other productivity and growth objectives. This will be the catalyst for a potential domino effect – private investment will fuel competitive returns, which in turn will drive economic and social growth, attracting further private investment.

Across Africa many industry verticals remain underpenetrated relative to both developed and other emerging markets, offering considerable growth opportunities for well-run businesses focused on solving domestic demand issues

Kayode Akinola
Partner
Alkima Capital

[3] https://www.aei.org/china-global-investment-tracker/
[4] https://www.brookings.edu/blog/africa-in-focus/2018/09/06/figures-of-the-week-chinese-investment-in-africa/
[5] https://www.investec.com/en_za/focus/investing/private-equity-in-africa.html

Fig. 3.15: Top 10 Investor Economies by FDI Stock, 2014 vs. 2018



Source: UNCTAD

4. Megatrends

A majority of both fund managers and investors believe ESG policies have a positive impact on returns, compared with **20%** of both citing a negative impact

Investor reporting (**74%**) and fund operations (**62%**) are the areas most likely to improve through technology, say LPs

Investors believe regulation will have a positive impact on the industry, but fund managers view it as negative

Measuring Success in ESG

Driven by regulations and investor demand, ESG has become mainstream in developed markets, but further adoption and integration into the investment lifecycle requires greater transparency and trust in the data

From a niche market to the mainstream, environmental, social, and governance (ESG) investing has reached critical mass as of late 2020. But where does it go from here?

Investment managers surveyed for *Future of Alternatives 2025* expect ESG policies to have more influence on their investment practices. Nearly 80% see a moderate (47%) to significant (33%) increase in their current ESG practices by 2025, with less than 1% expecting ESG to have less of an influence on their business.

Today, ethical considerations, demand from LPs, and best practice are the main drivers of ESG adoption (Fig. 4.1). More than a third (34%) of respondents think regulation will be a key ESG driver in 2025, though, up from 17% that regard it as such now. The impact of regulation is visible most clearly in Europe, where EU regulations pushed fund managers to adopt ESG principles. Of the $2.53tn of invested alternative assets in the region since 2011, 63% are managed under sustainable principles (Fig. 4.2).

What Is the Next Step?

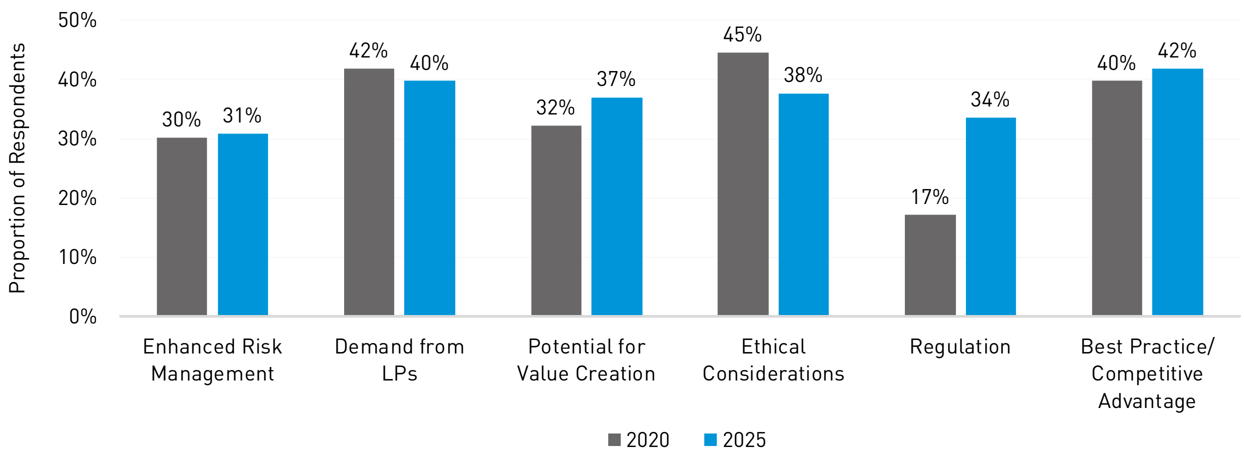
The ESG value proposition has been accepted by managers and investors alike. More than half (54%) of surveyed GPs say they believe ESG has a positive impact on returns, with 27% saying it has no impact and 20% a negative impact. The view is shared by LPs, with 58% seeing a positive impact, 21% no impact, and 20% a negative impact.

The next step is defining and making ESG objectively accountable. Efforts to standardize metrics and identify KPIs in ESG are still the holy grail; meanwhile, calls to make managers prove they are doing more than ticking boxes are getting louder.

Making Money and Doing Good Are Not Mutually Exclusive

Impact funds – investments with the dual goal of returns and positive contributions to society – are the next logical step for sustainable investing. While the total number of impact funds fell in 2019 and 2020 relative to the prior years, the assets invested in these funds have risen sharply. The average size of a 2020

Fig. 4.1: Fund Manager Views on What Is Driving the Adoption of ESG Monitoring and Reporting, 2020 vs. 2025



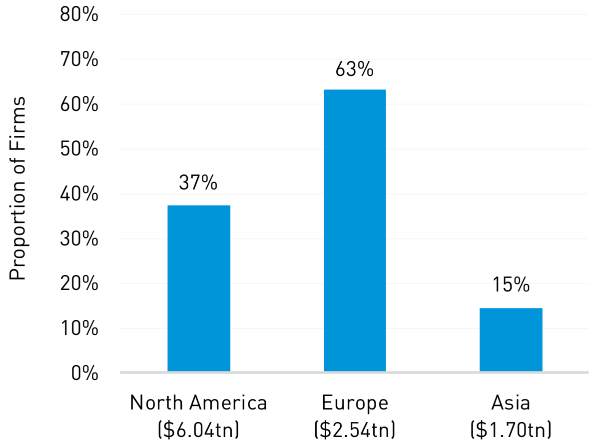
Source: Preqin Fund Manager Survey, August 2020

vintage impact fund is $1.3bn, almost double that of 2015 vintages (Fig. 4.3).

Impact funds have a compelling value proposition. Preqin research[1] has shown that these funds can equal peer returns and have diversification benefits. Returns of impact funds showed low correlation to ESG- and non-ESG-committed funds alike, and less variance.

The future of ESG lies in its value proposition becoming a natural part of the investment process, not in greenwashing. Groups like SASB and GRI are doing their best to help quantify an area with many subjective factors, but until these are tested and broadly accepted, further adoption from investment managers may level off until more can be done to put dollar values on ESG risk factors.

Fig. 4.2: Private Capital Firms that Have an ESG Policy in Place and Their Total AUM by Region



Source: Preqin Pro. Data as of November 2020

[1] *https://www.preqin.com/insights/research/blogs/investors-integrating-esg-can-indeed-do-well-by-doing-good*

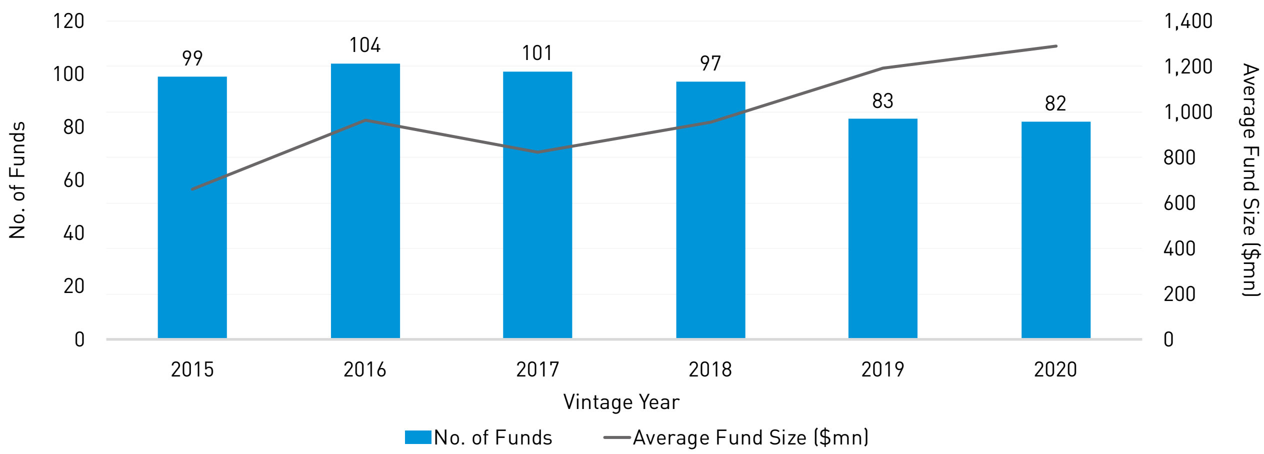
A Responsible Investing Policy framework is important, but for ESG to truly contribute to the creation of long-term value, it needs to be embedded into investment decision-making and portfolio management

Natasha Morris
Director, Responsible Investing
Adamantem Capital

At Preqin, we're focused on bringing our data expertise to ESG. By using the major frameworks and models to inform the data we gather, we're bringing transparency to what's happening in the market

Bob Vickers
Head of Product, Sustainability Finance Solutions
Preqin

Fig. 4.3: Average Size of Private Capital Funds with an ESG Policy in Place by Vintage Year



Source: Preqin Pro. Data as of September 2020

Why ESG Integration Will Be Key

Responsibility frameworks are a good start. But, as Natasha Morris of Adamantem Capital explains, it is only by fully integrating ESG into investment decisions and portfolio management that private equity firms will realize its value

Nothing shines a light on the importance of considering environmental, social, and governance (ESG) principles quite like a global pandemic. COVID-19 has made clear the link between a good understanding of ESG risks and opportunities in a business and the ability to manage its financial and operating performance during uncertainty.

The importance of ESG as a value enabler has come into sharp focus. For private equity it presents a big opportunity to re-tool economies through considered, sustainable investments. It will be a competitive and differentiating factor for attracting capital in a post-COVID world.

ESG as an End-to-End Solution

When it comes to fully integrating the consideration of ESG risks and opportunities into investment decision-making and portfolio company management, the practice is still in its infancy in Australia. A Responsible Investing Policy framework is important, but for ESG to truly contribute to the creation of long-term value, it needs to be embedded into investment decision-making and portfolio management.

The process should begin at the investment evaluation stage by fully integrating the consideration of how ESG risks and opportunities could impact business performance within the broader commercial due diligence process. This active incorporation of responsible investing needs to be carried through into portfolio company management, where it exists as an underlying value driver, guiding companies to evolve or adapt in line with best practice.

Natasha Morris
Director,
Responsible Investing

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Natasha Morris is Director, Responsible Investing at **Adamantem Capital**, a private equity firm with more than A$1bn in FUM. Focused on mid-market opportunities in Australia and New Zealand, our ambition is to deliver consistent returns for investors by supporting management teams to take risks, create change, and grow value. Adamantem is a signatory to the UN PRI, and a member of the Responsible Investment Association Australasia and the Climate Active Network.

At Adamantem, we work with management in due diligence and through the investment to address the business-specific risks and identify opportunities that may emerge from our ESG analysis. This might include reviewing a company's carbon footprint, approach to risk management, data and supply chain security, or workplace diversity. Most importantly, we are always cognizant of how our contribution, such as investing in additional talent, equipment, or bolt-on acquisitions, will impact the business long after our ownership period.

Using this ESG lens broadens the range of stakeholders that we, and our portfolio companies, consider as part of everyday decision-making, from employees, customers, and suppliers all the way through to the communities and environments we operate in. This means we are in a better position to develop an agile response to disruption (see below: 'De-Risked through ESG').

From Fad to Function

We do not see the focus on ESG as a passing trend. We can already see the relationship between positive impact and investment performance, and how we can deliver better outcomes for investors and enable the wider transition toward more sustainable economic activity.

Some observers question whether investors will maintain their focus on ESG once we are out of the pandemic and economies improve, or whether recent uncertainty will fuel risk aversion. We firmly believe there's never been a better time to fully integrate responsible investment approaches, taking something positive from this crisis and using it to drive investment and support management teams and companies in creating a more sustainable future.

De-Risked through ESG

Adamantem's portfolio companies founded their COVID-19 response plans on existing frameworks developed from ESG analysis. Robust identification of risks generated effective approaches to managing those risks and ensuring business continuity.

For example, one of our portfolio companies with numerous global supply chains had invested in strengthening and de-risking its supply chain, including implementing new inventory management processes to optimize stock. The work that was underway proved critical mid-pandemic as it afforded management the ability to quickly assess, analyze, and react to ensure minimal disruption to operations.

Another of our portfolio companies had recently developed new, robust governance practices, including the implementation of a business-wide risk management and reporting framework. This framework provided a very effective resource during the pandemic and equipped management with the tools to analyze, address, and accurately report the COVID-19 risks.

Why Investors Should Bank the Diversity Dividend

While investors recognize the performance benefits of diversity at fund managers, progress toward widespread implementation of formal policies will be slow

A majority of the alternative investment community recognizes that diversity of gender, experience, and cultural backgrounds in the workplace is a powerful defense against groupthink, can sharpen a team's decision-making ability, and improves investment outcomes. However, 19% of surveyed investors remain ambivalent about the benefits of a diverse workforce, while 22% believe that a diverse workforce makes no difference to reaching investment objectives (Fig. 4.4).

This may change over the next five years, though. The body of research linking diversity and inclusion to better investment outcomes is growing. A 2019 study by the International Finance Corporation[1] based on performance data from more than 700 private equity and venture capital funds found that those with gender-balanced senior investment teams generated investment returns that were 10-20% higher than those with a majority of male or female leaders.

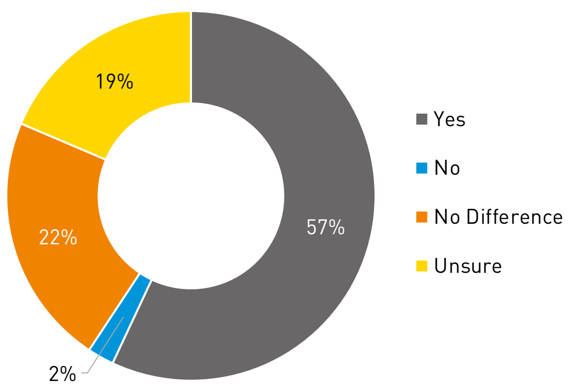
A study published in the Harvard Business Review[2] found that venture capitalists tend to partner others with the same gender, race, educational background, or previous employer. But homogeneous teams have been found to have worse investment outcomes. Collaborators with diverse traits are better equipped to help portfolio companies shape their strategy to thrive in a highly uncertain competitive environment.

Recognizing the Value in Diversity

Diversity is already influencing external manager selection, with institutional investors increasingly likely to include diversity criteria in their requests for proposals. Although only 13% of investors surveyed

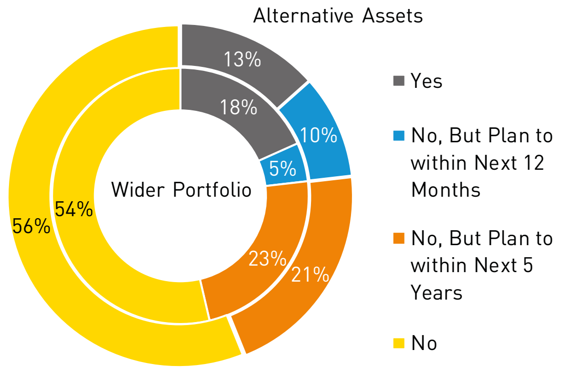
[1] *https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/gender+at+ifc/resources/gender-balance-in-emerging-markets*
[2] *https://hbr.org/2018/07/the-other-diversity-dividend*

Fig. 4.4: Investor Views on Whether a Diverse Workforce Is Beneficial to Reaching Investment Objectives



Source: Preqin Investor Survey, August 2020

Fig. 4.5: Investors with a Diversity Policy in Place for Investment Managers: Alternatives vs. Wider Portfolio



Source: Preqin Investor Survey, August 2020

for *Future of Alternatives 2025* have a diversity policy in place for hiring investment managers in alternatives, 10% expect to implement a policy in the next 12 months and a further 21% will within five years (Fig. 4.5). Given that 57% of respondents see the benefits of diversity, and that the implementation of diversity policies in alternatives lags the wider portfolio, it is likely to be only a matter of time before this thinking is formalized.

Research by Preqin[3] has shown that more than three-quarters of total assets across the alternatives industry are managed by GPs with confirmed policies in place for diversity and inclusion. In other words, the largest GPs are already anticipating that the diversity agenda will gather momentum in the years to come, and are striving to position themselves as thought-leaders in this space.

Some managers do it to check the box for their investors. Then there are people who truly believe that ESG and diversity are better for business, and those are the people that are thinking about the fundamentals, the longer term, and doing what's right for our industry and the world at large

Kelsey Banos
Managing Director
First Republic Bank

Fund Managers Open up to Inclusion

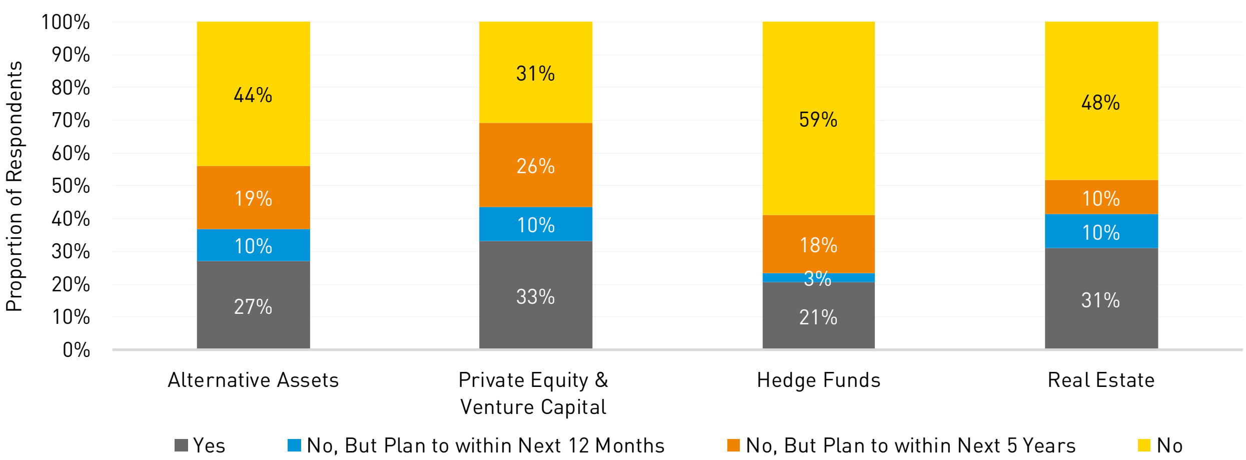
While a large majority (73%) of surveyed fund managers don't currently have a diversity policy in regards to their investment practices, 10% said they plan to adopt a policy within the next 12 months (Fig. 4.6). A further 19% plan to do so over the next five years.

This level of buy-in is encouraging and not at all surprising. The investing community's fixation with star analysts or hedge fund 'masters of the universe' has gradually worn away with time, with the dominant model one that places a focus on investment teams.[4] High-functioning teams pay attention to how decisions are made and who is included in them, and this is the heart of what inclusion means – how firms harness the diversity of their workers to the maximum advantage.

As we move toward 2025, we expect to see alternative asset managers further develop metrics to track progress and spot areas of weakness around the diversity agenda, mostly in response to investor demand. When the benefits are both seen and believed, the more progressive GPs will pay serious attention to extending formal diversity and inclusion practices across their investment portfolios.

[3] *https://www.preqin.com/insights/research/blogs/larger-managers-are-more-likely-to-prioritize-diversity-and-inclusion*
[4] *https://www.cfainstitute.org/-/media/documents/survey/diversity-and-inclusion-report-full.ashx*

Fig. 4.6: Fund Managers on Whether They Have a Diversity Policy in Regards to Their Investment Practices by Asset Class



Source: Preqin Fund Manager Survey, August 2020

Big Data Will Drive Big Changes in Fund Operations

Advances in data analytics and investor demand for more information will drive data-oriented organizational transformation

'Big data' is a catch-all term used to refer to large and complex datasets that often cannot be handled by traditional software such as Microsoft Excel. Such data might take the form of social media posts or geolocation data that cannot be organized into neat tables without some processing. In these cases, machine learning algorithms would be trained to read through the data to spot patterns and trends. At the heart of big data is the idea that as new forms of data become analyzable, firms have more tools to deploy to improve their decision-making.

While data-driven models have been used by many quantitative hedge funds for years to find new sources of alpha, and some private equity firms are also using big data to inform their investment decisions, this technology is still very new to most. A majority (59%) of fund managers polled by Preqin for *Future of Alternatives 2025* do not currently harness big data in any way (Fig. 4.7). We will see an increase in the adoption of machine learning and other data-processing techniques over the next five years: 42% of respondents say they will use big data more by 2025.

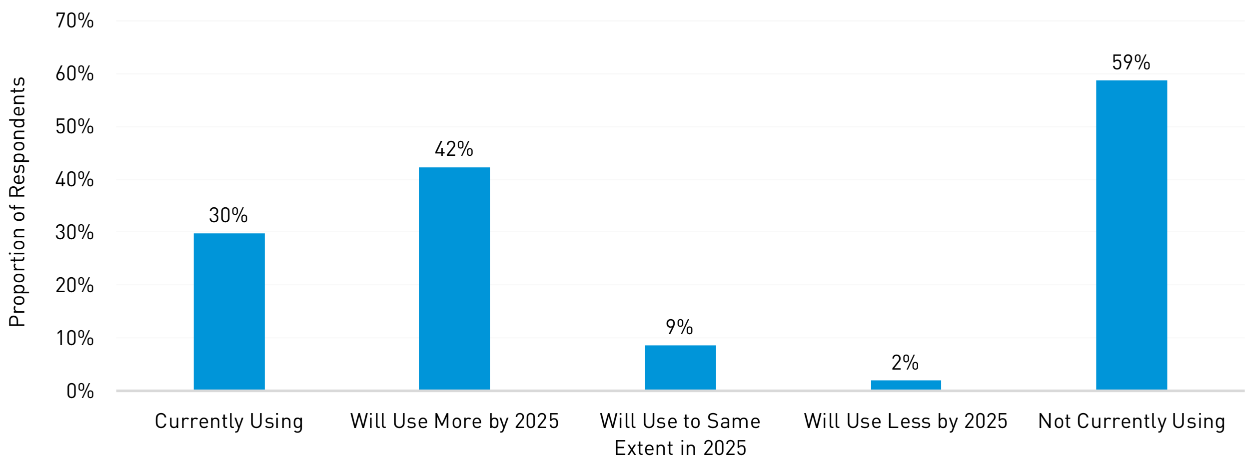
Data Integration Efficiencies

However, two forces will push managers to develop clear data strategies going into 2025. First, investors are increasingly demanding more data from managers, and they want this information delivered to them faster, and in the exact format they require. Second, as funds come under more pressure to keep operating costs down, many aspects of fund administration and reporting that still rely on manual processes will have to be replaced with scalable and more efficient data integration and data management solutions.

At larger funds, talent with quantitative research and data science backgrounds will be in demand. Smaller managers may not have the resources to build their own analytics tools, and will look instead to outsourcing. Investment service providers and fund administrators are already investing heavily in various portfolio analytics tools and interactive dashboards. At Preqin, for example, we have used our expanding database of funds to develop a cash flow forecaster[1] that enables LPs to model the exact timing and size of capital calls and distributions for a specific fund

[1] *https://go.preqin.com/cash-flow-forecaster*

Fig. 4.7: Fund Manager Views on How Their Use of Big Data Will Change over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

or collection of funds. This helps LPs monitor their liquidity risk, make better re-investment decisions, and visualize how returns will evolve over time. Prospective LPs also use Preqin's J-curve and cash flow pacing benchmarks to screen for GPs that best match their performance, liquidity, and risk management constraints.

Outside of fund operations and portfolio management, investor relations are another area that could benefit significantly from the use of technology over the next five years (Fig. 4.8). Some respondents are planning to use AI to automate interactions with existing and potential LPs; the client insights they glean from models enable them to be more targeted in sales and marketing efforts. Some managers are using predictive algorithms to identify specific product cross-sell opportunities, while others have algorithms that can identify clients at risk of redemption for specific strategies, according to McKinsey.[2]

We expect a gradual increase in the use of analytical tools to capture and present data more effectively. Key to the adoption will be the role of external providers, including technology firms, data providers, consultancies, and professional services firms, who have the scale and business model to develop practical solutions.

[2] *https://www.mckinsey.com/industries/financial-services/our-insights/advanced-analytics-in-asset-management-beyond-the-buzz*

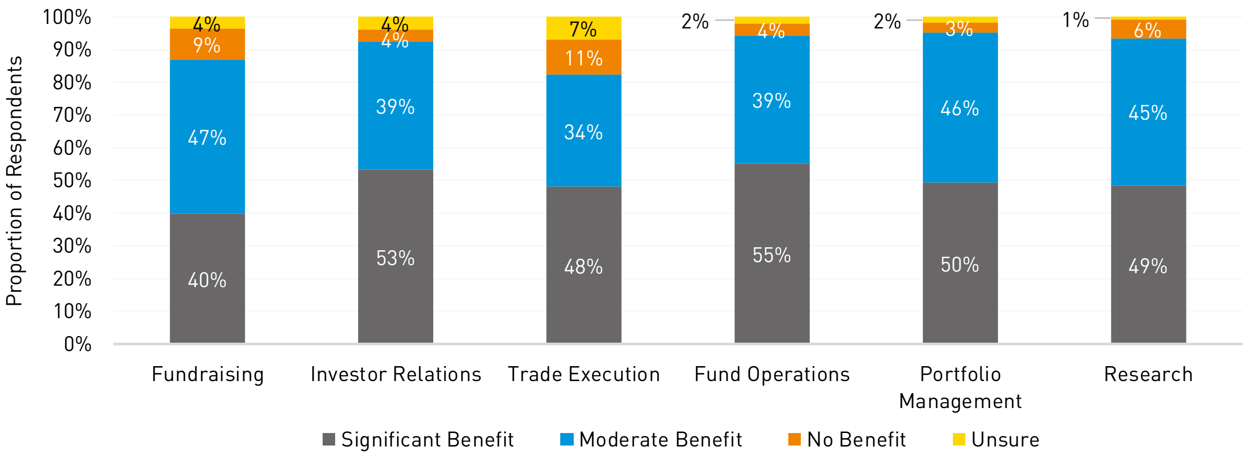
AI and data science will impact all walks of life beyond the current information technology and healthcare sectors. If applied correctly, it can improve lives and enhance productivity in the workplace – including venture capital investing and portfolio management

Chua Kee Lock
President & CEO
Vertex Holdings

Technology can bring significant differentiation to many parts of a manager's operating model: from deal-sourcing and analysis using machine learning, through to automated AML/KYC platforms and digital board meetings. We are at the beginning of this journey, but by 2025 a digital-first operating model will be the standard

Nikolaos Perros
Head of Private Equity
Citco Fund Services (USA) Inc.

Fig. 4.8: Fund Manager Views on Areas that Will Benefit from Technology over the Next Five Years



Source: Preqin Fund Manager Survey, August 2020

The Future of Value Creation in Private Markets Is Digital

Alternative fund managers and investors will need to embrace growing pressures for digital transformation across the industry to compete effectively and drive value creation

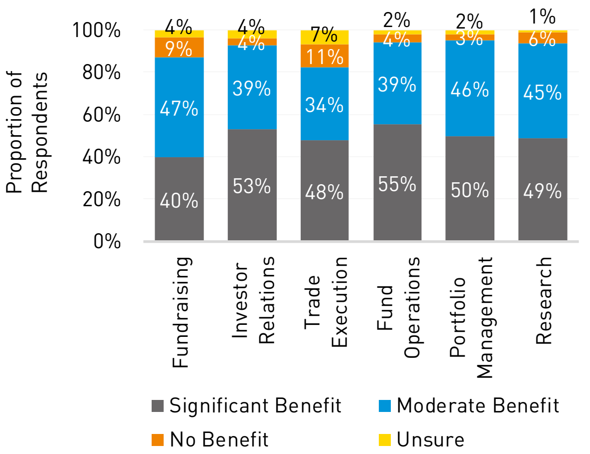
Rapid technological innovation is creating a more digitally driven world economy. Every sector must adapt and redefine the way business is conducted at all levels, and the private capital industry is no exception.

As the speed of digital advancements increases, fund managers and investors both agree that technology will play a bigger role in private markets over the next five years. More than half of surveyed fund managers see fund operations (55%) and investor relations (53%) benefiting significantly from the use of technology, compared to only 4% expecting no benefit in these areas (Fig. 4.9). On the LP front, 74% believe technology adoption in investor reporting will offer significant business benefits by 2025, while 62% have the same outlook for fund operations (Fig. 4.10).

What Is Driving the Digital Trend?

The alternative investment industry is no stranger to technology – information has always been its lifeblood – but competition is rising across all asset classes as AUM continues to soar.

Fig. 4.9: Fund Manager Views on Areas that Will Benefit from Technology over the Next Five Years

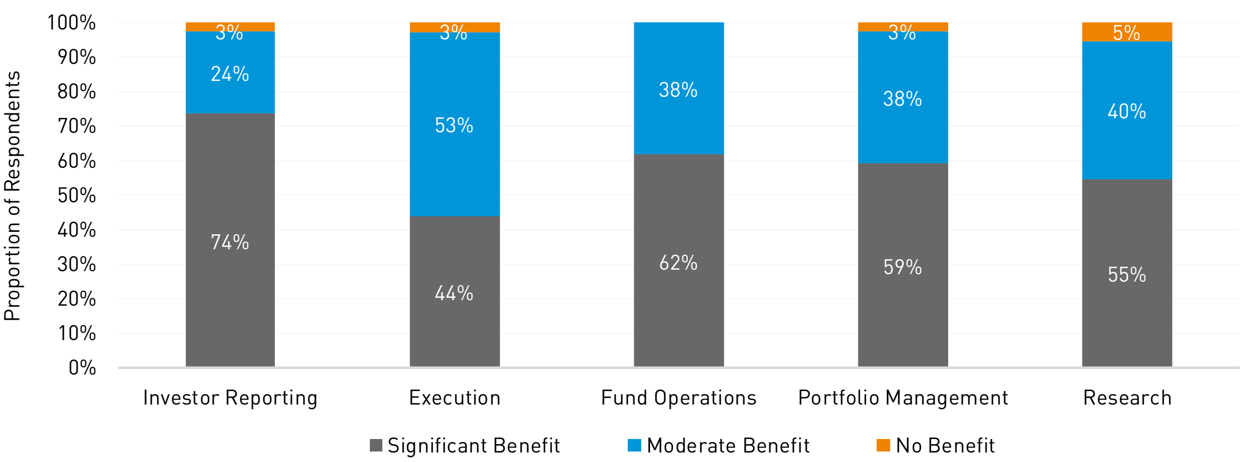


Source: Preqin Investor Survey, August 2020

Research by KPMG[1] found that rising fee competition and cost pressures were key structural drivers for alternative fund managers considering the digitization

[1] *https://assets.kpmg/content/dam/kpmg/xx/pdf/2018/01/alternative-investments-3-0-digitize-or-jeopardize.pdf*

Fig. 4.10: Investor Views on Areas that Will Benefit from Technology over the Next Five Years



Source: Preqin Investor Survey, August 2020

of their business over the next three years, with price competition between GPs expected to heat up. Improved management fee alignment between LPs and GPs was a key area for over half (56%) of global investors, according to *The 2020 Preqin Private Capital Fund Terms Advisor*.

LPs are also demanding more transparency and seamless data sharing from their GPs to make more informed risk management decisions. A significant majority of global alternative investors we surveyed said that inconsistent reporting formats (73%) and insufficiently detailed information (66%) from fund managers are key challenges to investing from a technology perspective (Fig. 4.11).

Technology Adoption Is a Must, Not a Differentiator

There is no doubt that technology will play a key role in the next wave of industry growth over the coming five years. We expect the advantages of technology will go far beyond traditional cost-saving automation and paper-process digitalization for fund operations or compliance – it will more holistically address the entire alternative investment value chain.

The technological capabilities allowing for smooth, fully digital investor journeys, AI-enhanced due diligence, greater disintermediation, and new data-driven investment strategies are becoming a more widely adopted reality. Private market stakeholders that are willing to fluidly redesign existing business models and adapt to a more digitally oriented world will flourish.

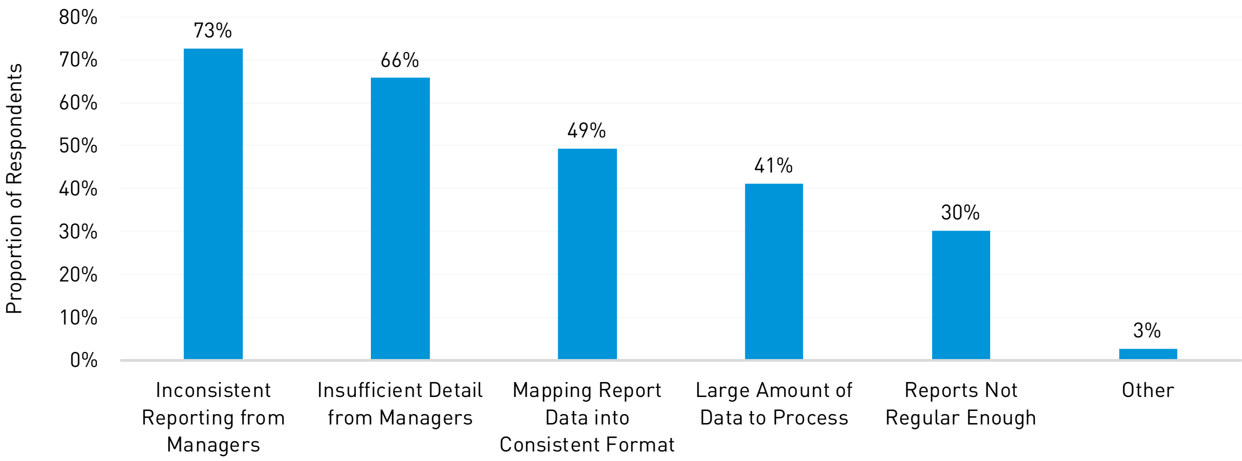
With the increasing intensity of competition and the volatile economic outlook, organizations must display agility and adaptability by leveraging dynamic and innovative technologies that cater to market trends and changing consumer behaviors

Dr Karim El Solh
Co-Founder and CEO
Gulf Capital

Innovation is a global phenomenon. Successful VCs need deep, local networks and global connectivity to realize meaningful opportunities for disruptive/transformational technology insights, deal sourcing, due diligence, and portfolio value creation opportunities

Chua Kee Lock
President & CEO
Vertex Holdings

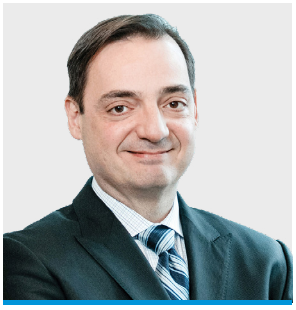
Fig. 4.11: Investor Views on the Challenges of Investing in Alternative Assets from a Technology Perspective



Source: Preqin Investor Survey, August 2020

Why a Symbiosis between Fund Manager and Administrator Will Be Key

We sat down with Nikolaos Perros, Head of Private Equity at Citco Group, and Kenneth Leong, COO & CFO at Axiom Asia Private Capital, to discuss the future of private equity and fund administration in Asia amid growing industry competition, evolving LP expectations, and digital transformation



Nikolaos Perros
Head of Private Equity

Citco Fund Services (USA) Inc.
www.citco.com

Kenneth Leong
COO & CFO

Axiom Asia Private Capital
www.axiomasia.com

Asia-Pacific is a booming market for private equity. How is private equity and fund administration evolving in this region?

Nikolaos Perros: The number of Asia-based private equity managers raising new funds targeting the region has been rising in recent years. Global investors and allocators, seeking to gain exposure to this fast growth region, have increasingly shifted their allocation interests in favor of local fund managers.

Kenneth Leong: The PEVC landscape is becoming more competitive and complex. On the deals front, money is not as scarce as it was before, there is a lot of capital chasing deals, and private companies have more options for financing today beyond just private equity growth funds. Driving continued growth in portfolio companies and differentiating yourself as a fund manager to investors is also becoming more challenging.

How do you see fund administration changing by 2025?

Kenneth Leong: LPs are increasingly sophisticated. In the past, stakeholders may have been happy to receive standardized reports from their GPs on a regular basis. Now, investors want not only more detailed information, but data available to them in a timely manner with quick turnarounds on any request. Basic things – even waterfall charts that used to be done manually on Excel spreadsheets – just won't cut it anymore.

Nikolaos Perros: There is a new belief that technology can bring significant differentiation to many parts of a manager's operating model: from deal-sourcing and analysis using machine learning, through to automated AML/KYC platforms and digital board meetings on iPads. In 2020 we are at the beginning of this journey, but by 2025 a digital-first operating model will be the standard across all top-tier managers and administrators.

With technology playing a bigger role in fund administration, operational vulnerabilities are changing, driving fund administrators and GPs toward a more holistic understanding of the evolving risks. Cybersecurity concerns, for example, are now top of mind and will be into the foreseeable future.

What factors are driving these trends across the private equity industry?

Nikolaos Perros: Investors and managers have understood how important data is to their decision-making processes. For example, if investors wish to compare the costs and performance of their holdings, they need consistent clean data from their managers. If managers want to understand and forecast the carry generated by their investments, they need digital tools with accurate data too.

Additionally, there is a more utilitarian force at work. The private equity industry is more global than ever. Operating in the old face-to-face, wet-ink manner is impractical for today's fund managers. Digital document signing, virtual meetings, virtual board packs, cloud document storage, and much more, are all now a standard part of operational toolkits.

Kenneth Leong: Besides competition on the deals and fundraising front, stakeholders are looking for improved efficiency in their relationships with GPs. Possessing robust, streamlined operational processes that can cope with more complex business requirements is something that can set you apart from peers.

What are the biggest challenges facing the future of fund administration?

Nikolaos Perros: There are two key challenges facing fund administrators in this digital future. The first is data access. All of the advantages technology can bring are dependent on accurate and timely data being available to all participants. The second challenge is the tendency of industries to become commoditized. In the past 20 years we have seen this happen in the custody space, then in the UCITS fund administration space, and most recently in hedge fund administration. As technology enables more straight-through processing and less reliance on people, how will administrators react and stay valuable to managers? The answer here is that administrators must become providers of insight.

Kenneth Leong: Fund administration as an industry will need to evolve to better understand the dynamic needs of their clients that go far beyond the traditional services of standard fund accounting. Going forward, improving system integration between GPs and fund administrators will become more important as data increasingly needs to move seamlessly and quickly between platforms.

I still think regulatory issues in general – including KYC and AML considerations – will continue to place pressure on GPs and fund administrators. Compliance requirements are increasing and investors are facing new demands when allocating to fund managers.

In this environment, will fund administrator relationships become more important?

Nikolaos Perros: If administrators can move their provision of service to be a value-add one, far beyond the offering of solutions, then there can be a hugely beneficial symbiosis between manager and admin. An administrator can help a manager create operational differentiation or operational alpha to help them stand out and become more resilient in times of uncertainty.

Kenneth Leong: Fund administrators that understand the need to evolve with you on your own operational journey will be key. This relationship is increasingly a two-way street today, where constructive feedback and adjustment allow both parties to ultimately arrive at a process that delivers real value-add.

Lack of Alternative Options Will Drive Allocations

Equity valuations and low yields from fixed-income investments are set to boost alternatives allocations, driving significant growth

The alternative assets market has grown significantly in recent years, and Preqin expects AUM to reach $10.74tn at the end of 2020. Our AUM forecasts show alternatives rising to $17.16tn at the end of 2025, but are there limits to the size of the market? We would argue not.

Alternative assets are generally an important part of a wider multi-asset portfolio, performing a vital role in the balance of risk and return. The illiquid nature of most alternative assets can act as a counterweight to listed equity and tradable fixed-income portfolios, which can balance cash flow needs within a portfolio due to their liquid nature and can reprice quickly. This creates a real-time view for investors, which is not always reflected in their alternative assets investments given the way they are valued. Without immediate revaluation, private assets can smooth volatility, as we have seen with some assets during 2020.

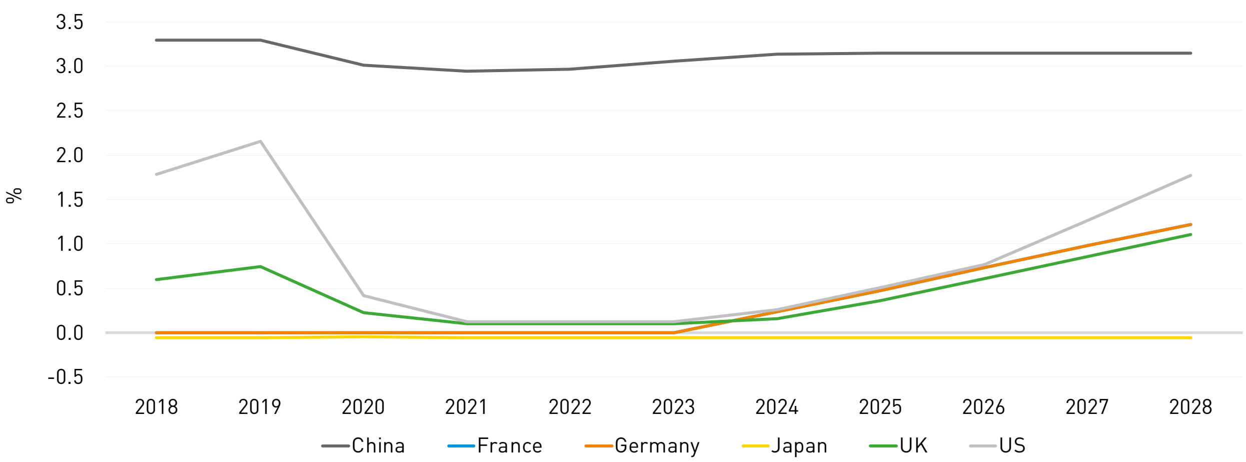
The Interest Rates Effect

Allocations to alternative assets are a key driver of market growth. The outlook for the next several years appears to be a further period of low or negative real interest rates across major economies. Central bank policy rates in the major developed economies of the US, Japan, Germany, France, and the UK are expected to remain below 0.5% through to 2025, according to Oxford Economics (Fig. 4.12).

This is pushing investors to seek either alternative sources of yield or new sources of growth, given the speed of the equity recovery during Q2 and Q3 2020. The S&P 500 trades on a forward P/E of 20.9X estimates for calendar year 2021, compared with an average of 20.5X for 2016-2020F.[1] It could be argued that at this point in the cycle, with so much uncertainty, equity markets are aggressively valued.

[1] *FactSet as of 9 October 2020*

Fig. 4.12: Central Bank Policy Interest Rates, 2018 - 2028



Source: Oxford Economics

The combined forces of high equity valuations and negative yields from many government bonds are expected to push more investors toward alternative assets. In a recent investor presentation[2] Brookfield Asset Management argued that allocations to alternatives could increase from 25% in 2019 to 60% in 2030. If this came to pass, AUM would surge from existing levels.

When valuations are solid, equity markets play a significant role in exits, allowing capital to be recycled. Preqin data in Q3 2020 highlighted a significant increase in the number of exits via IPO across the venture capital industry, which helped push exit valuations to a new quarterly record of $118bn.[3] Trade sales also have a very important role to play and still dominate exits across alternative assets markets, including venture capital, with high valuations making it easier for listed acquirors to pay top dollar.

The Benefits of Oversight

Throughout 2020, one major benefit of private equity ownership has been the close relationship between managers and portfolio companies, with direct reporting lines between executives and shareholders and access to far more detailed financial performance numbers than listed companies disclose to their investors. Operating through times of crisis has proven the model can work in the most difficult of economic environments, which may alleviate concerns among potential investors about the strength of leveraged investee companies.

With a wide range of drivers for future growth in the alternative assets market and several potential ways in which participants can deploy and redistribute capital, there appears to be few obstacles in private capital's path to future growth as a major asset class that complements public capital markets.

Alternative assets are generally part of a wider multi-asset portfolio, performing an important role in the balance of risks and returns. The illiquid nature of most alternative assets can act as a counterweight to listed equity and tradable fixed-income portfolios

Dave Lowery
Head of Research Insights
Preqin

[2] *https://bam.brookfield.com/~/media/Files/B/BrookField-BAM-IR-V2/ir-day/2020/BAM%202020%20IR%20Day-Final.pdf*
[3] *https://www.preqin.com/insights/research/quarterly-updates/preqin-quarterly-update-private-equity-and-venture-capital-q3-2020*

Full and Frank Disclosure

Regulation of alternative assets is increasing, but also creating new markets and opportunities. As the industry grows it will need to open up to greater scrutiny

With investors craving predictability and stability, financial markets breathed a sigh of relief at the outcome of the US election.[1] It was not so much that the vast majority of campaign contributions from the private equity, hedge fund, securities, and investment industries went to the Democratic candidate, more that the division of power across the Senate and House of Representatives reduces the likelihood of sweeping changes to either regulations or taxes.

Indeed, surveyed fund managers are more concerned about regulation over the next five years than any other external factor affecting their business (Fig. 4.13). Two-thirds of fund managers say regulation will have a significant (18%) or slight (49%) negative impact. Domestic politics and barriers to trade were also viewed negatively by just under 60% of fund managers.

While investors held similar views to fund managers on domestic politics, barriers to trade, and a host of other factors, they were markedly more positive on regulation. Forty-six percent of investors predict regulation will have a slightly positive (34%) or significantly positive (12%) effect on their business in the next five years. The findings highlight the contradictions that surround the impact of regulations on any industry.

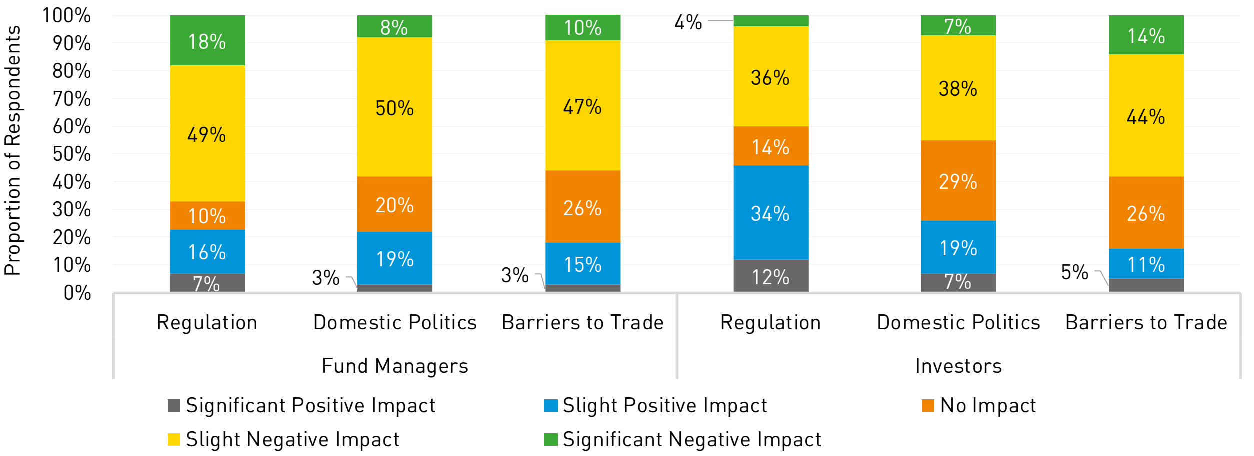
Business people generally see regulation as a burden, though closer examination reveals that these burdens can drive positive changes in business practices. The three factors currently driving the adoption of ESG investing[2], monitoring, and reporting according to surveyed fund managers were ethical considerations (45%), demand from LPs (42%), and best practice/competitive advantage (40%, Fig. 4.14). When looking ahead to 2025, these factors are also expected to be key drivers of ESG investing, but the biggest changes in responses were for regulation (up from 17% to 34%) and potential for value creation (up from 32% to 37%.)

Regulations Can Create Markets

Regulation is also driving the decarbonization agenda. The 2016 Paris Agreement crystalized the commitment to reduce carbon emissions, and the direction of travel is toward more ambitious targets: the EU proposed a

[1] *https://www.preqin.com/insights/research/blogs/how-the-2020-election-could-affect-the-us-alternatives-landscape*
[2] *https://www.preqin.com/insights/research/blogs/future-of-alternatives-2025-measuring-success-in-esg*

Fig. 4.13: Fund Manager and Investor Views on How Stimuli Will Impact Their Business over the Next Five Years



Source: Preqin Fund Manager and Investor Surveys, August 2020 new 2030 carbon reduction target of 55% and proposed that its commitment to become carbon neutral by 2050[3] should be legally binding. The EU has also strongly tied its coronavirus recovery packages to green initiatives. This will create investment opportunities in technology and infrastructure for energy efficiency, renewable energy, and low-carbon technologies.

Over the past 25 years alternative assets have moved from a niche industry to a mainstay of most large investors' portfolios. Improvements in reporting of fund performance and benchmarking, driven by firms like Preqin, were made possible by investors' regulatory reporting obligations.

Preqin strongly believes that improvements in transparency will have long-term benefits. The public perception of alternatives segments, especially the most high-profile asset classes of private equity and hedge funds, is negative, with the terms used as a pejorative for the excesses and ills of capitalism. When people take a closer a look at how alternatives work, such as with the alignment of stakeholders' interests or closer governance and monitoring, their view of these asset classes improves.

Industry bodies such as the American Investment Council, Invest Europe, and BVCA have invested heavily in research showing the benefits their members' investments bring. For example, Invest Europe's Private Equity at Work[4] report says private equity-owned companies employ 10.5 million people and create jobs 5x faster than the European average.

[3] *https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1599*
[4] *https://www.investeurope.eu/research/private-equity-at-work-1/*

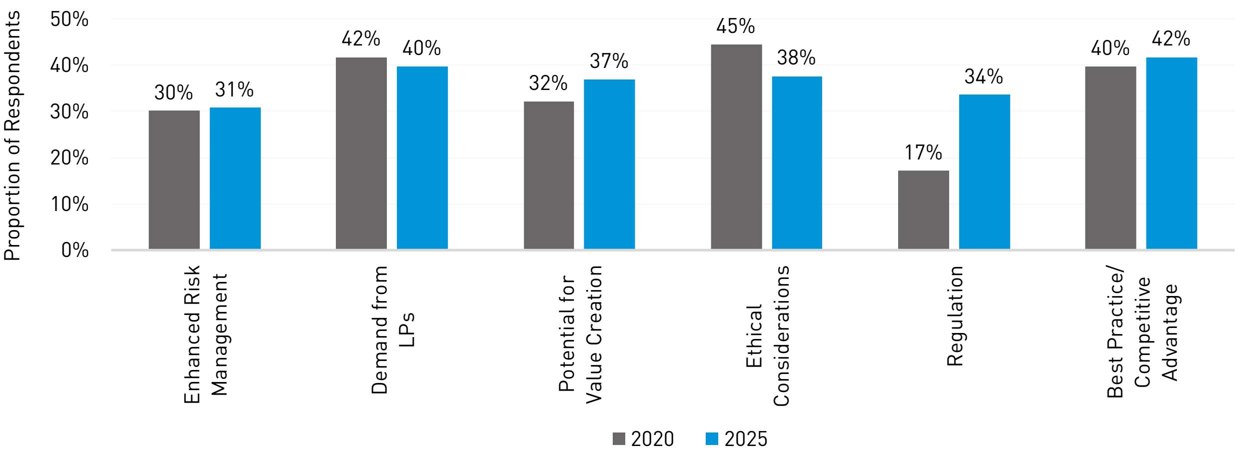
Private equity is an engine for growth. The industry is a major supporter of employment across the whole continent. Not only do its companies create jobs, but they do it at a much faster rate than the average European business

Eric de Montgolfier
CEO
Invest Europe

When you lift the lid and see what private investors really do, there's a lot to shout about. The ownership model has many advantages and companies supported by private capital create more jobs, launch more products, export more, invest more in R&D, and grow revenues and profits faster

Mark O'Hare
CEO
Preqin

Fig. 4.14: Fund Manager Views on What Is Driving the Adoption of ESG Monitoring and Reporting, 2020 vs. 2025



Source: Preqin Fund Manager Survey, August 2020

The Recovery from Long COVID

The effects of the COVID-19 pandemic will last many years, but not all will be detrimental to the alternatives industry

As 2020 draws to a close, hopes are rising that an effective vaccine will allow life to return to normal. But normal after COVID-19 will likely look very different to normal a year ago.

Alternatives have not escaped the virus. For the first time this century, AUM will be lower at the end of the year (forecast at $10.74tn) than they were at the start ($10.82tn). Deal volumes and values will be down across asset classes, with the notable exception of venture capital, where aggregate deal value surpassed 2019's $285bn in November, according to Preqin Pro. The widespread deployment of loan support for companies and monetary easing means that the extent of problems within the corporate sector is difficult to access. But, if the experience of the GFC is any indicator, private capital-controlled companies will outperform.

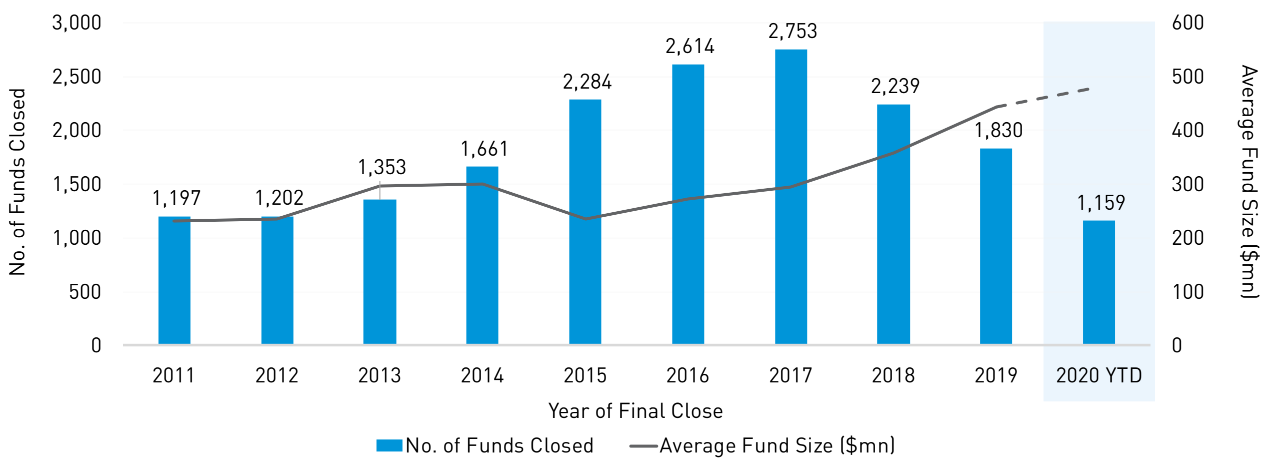
Considering the unprecedented disruption, transactional processes have functioned remarkably well. In many ways, the main impact of the pandemic has been to accelerate already established trends. For example, the number of private equity and venture capital funds closed each year has been declining since 2017, while their average size has increased in tandem (Fig. 4.15).

Investors and fund managers transitioned well to remote working and video calls, while much of the machinery of investment, such as virtual data rooms, was already in widespread use. In some respects, the ease, efficiency, and intimacy of electronic communications have deepened existing relationships, with GPs now in much more frequent contact with their LPs.

Adapting to the New Environment

The mechanics and practice of investing are unlikely to return to pre-COVID norms. While face-to-face meetings will remain crucial to establishing new relationships for both investors and managers, a larger proportion of ongoing relationship management will take place online.

Fig. 4.15: Number and Average Size of Private Equity & Venture Capital Funds Closed, 2011 - 2020 YTD



Source: Preqin Pro. Data as of November 2020

The pandemic will have impacts that stretch beyond the virus and its economic effects. Canada Pension Plan Investment Board (CPPIB) says it could trigger a generational shift in attitudes[1], as we saw with the thriftiness of those that lived through the Great Depression, the stoicism of the WWII generation, or even the reduced spending habits of the cohort who entered the workplace during the GFC.

Not all COVID-related changes will be negative for alternatives investors. The digital transformation[2] agenda has been accelerated across many industries and we expect this to be a value creation lever for investment firms. Some fund managers, such as Australian private equity firm Adamantem[3], found that their ESG assessments formed the basis of their COVID response in areas such as diversifying supply chains.

Investment sectors such as edtech and healthtech have been turbocharged by the pandemic. Aggregate venture capital deal value in healthcare was a shade below $10bn in each quarter of 2019, but in 2020 rocketed to $17bn in the third quarter (Fig. 4.16). The rise is mostly explained by increasing ticket sizes, with the average deal value rising from less than $20mn to more than $30mn in both the second and third quarters of 2020. Medical practices enforced by the pandemic and encouraged because of it, such as virtual doctor's consultations, will become much more common.

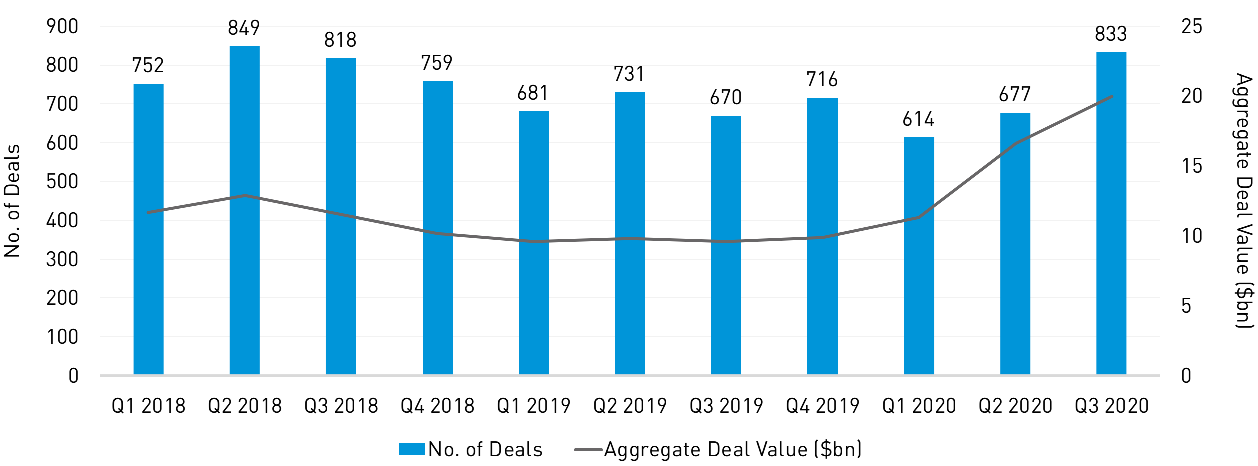
Ultimately, we expect alternatives to come out the other side of the pandemic in a strong position, at least in terms of the size of the industry. Probably the biggest legacy will be the continuation of ultra-low interest rates, which will force investors of all shapes and sizes to take a closer look at alternatives as means of meeting their funding obligations and liabilities.[4] After a brief pause, we expect AUM in alternatives to resume growing and reach $17.16tn in 2025.

Time and again, the alternative assets industry has proven itself to be agile and adaptive; and the COVID period will be no exception. The industry can and will evolve at breakneck pace to serve the needs of its investors and wider stakeholders. Preqin is excited and honored to play a leading role in serving the industry and supporting its development and success

Mark O'Hare
CEO
Preqin

[1] *https://www.cppinvestments.com/insights/how-covid-19-is-shaping-the-landscape-for-long-term-investors*
[2] *https://www.preqin.com/insights/research/blogs/the-future-of-value-creation-in-private-markets-is-digital*
[3] *https://www.preqin.com/insights/research/blogs/why-esg-integration-will-be-key*
[4] *https://www.preqin.com/insights/research/blogs/future-of-alternatives-2025-investors-inexorable-push-to-alternatives*

Fig. 4.16: Quarterly Global Venture Capital Healthcare Deals, Q1 2018 - Q3 2020



Source: Preqin Pro

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